FAMILY ENTERPRISE ESTATE AND GIFT TAX EQUITY ACT AND MISCELLANEOUS TAX BILLS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 2775, S. 2805, S. 2818, S. 2904, S. 2967, and H.R. 7171

AUGUST 4, 1980

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FAMILY ENTERPRISE ESTATE AND GIFT TAX EQUITY ACT AND MISCELLANEOUS TAX BILLS

MONDAY, AUGUST 4, 1980

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
Washington, D.C.

The subcommittee met, pursuant to call, at 9 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd Jr., (chairman of the subcommittee) presiding.

Present: Senators Byrd, Nelson, Bentsen, and Packwood.

[The press release announcing this hearing and the bills S. 2775, S. 2805, S. 2818, S. 2904, S. 2967, H.R. 7171, and the Joint Committee on Taxation description of these bills follows:]

Press Release No. H-40

PRESS RELEASE

FOR IMMEDIATE RELEASE
July 25, 1980

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON S. 2967, THE FAMILY ENTERPRISE ESTATE AND GIFT TAX EQUITY ACT AND MISCELLANEOUS TAX BILLS

Senator Harry F. Byrd, Jr., Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on Monday, August 4, 1980, on S. 2967 introduced by Senators Nelson, Byrd (of Virginia), Wallop, and Eagleton, and miscellaneous tax bills.

The hearing will begin at 9:00 a.m. in Room 2221, of the Dirksen Senate Office Building.

Senator Byrd noted that S. 2967 is the result of suggestions which the Subcommittee on Taxation and Debt Management received in previous hearings on proposals to revise the gift and estate tax laws.

"S. 2967 is designed to meet the liquidity problems which many estates face and compensate taxpayers for the effects of inflation upon assets which have been held for many years."

Senator Byrd also indicated the bill clarifies technical problems now in the estate tax law.

Following the consideration of S. 2967 the following miscellaneous measures of general application, unless otherwise specified, will be considered. Revenue estimates will be furnished at the hearing.

S. 2775 - Introduced by Senator Bentsen. Under specified conditions, would exempt foreign pension plans from the tax provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

S. 2805 - Introduced by Senator Nelson. Would provide that revenue ruling 80-60 cannot require a change in the taxpayer's method of accounting for taxable years beginning before 1980. Revenue ruling 80-60 implemented the Supreme Court case of *Thor Power Tool Co. v. Commissioner*.

S. 2818 - Introduced by Senator Talmadge. Would provide that pole rental and display listing income will not be treated as unrelated business taxable income to tax-exempt mutual or cooperative telephone companies.

S. 2904 - Introduced by Senator Talmadge. Would adjust the excise tax rate on highway tires from 10 cents per pound to 9.75 cents per pound and make other changes relating to the excise tax on rubber tires.

H.R. 7171 - Sections one, four, and five only. Section one would provide that Federal grants for college tuition are not includable in gross income merely because the recipient must render future service as a Federal employee. Section four would provide rules for the treatment of railroad stock in consolidated returns. The principal beneficiary of this section is the Norfolk and Western Railway Company. Section five would provide rules relating to the treatment of net operating losses in railroad reorganizations. The principal beneficiary of this section is the Erie Lackawanna Railway Company.

Witnesses who desire to testify at the hearing must submit a written request, including a mailing address and phone number, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C. 20510, by no later than the close of business on July 30, 1980.

Consolidated Testimony.--Senator Byrd also stated that the Committee urges all witnesses who have a common position or the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. This procedure will enable the Committee to receive a wider expression of views than it might otherwise obtain. The Chairman urges very strongly that all witnesses exert a maximum effort, taking into account the limited advance notice, to consolidate and coordinate their statements.

Legislative Reorganization Act.--Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Subcommittee, but are to confine their oral presentations to a summary of the points included in the statement.

Written Statements.--Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D. C. 20510, not later than August 29, 1980.

P.R. # H-40

II

96TH CONGRESS
2D SESSION

S. 2775

To amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

IN THE SENATE OF THE UNITED STATES

JUNE 2 (legislative day, JANUARY 3), 1980

Mr. BENTSEN (for himself, Mr. TALMADGE, Mr. MOYNIHAN, Mr. BAUCUS, Mr. DOLE, Mr. CHAFEE, and Mr. WALLOP) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 404 of the Internal Revenue Code of 1954
4 (relating to deduction for contributions of an employer to an
5 employees' trust or annuity plan and compensation under a
6 deferred-payment plan) is amended by adding at the end
7 thereof the following new subsection:
8 "(i) PLAN MAINTAINED FOR NONRESIDENT ALIENS.—

1 "(1) IN GENERAL.—If the conditions of section
2 162 or section 212 are satisfied, in the case of a plan
3 described in this section (other than a plan with respect
4 to which deductions are claimed under subsection (a)
5 (1), (2), or (3)) which during the taxable year is main-
6 tained primarily for the benefit of persons substantially
7 all of whom are nonresident aliens, subsections (a)(5)
8 and (d) shall not apply (unless the taxpayer elects to
9 apply either of those subsections with respect to such
10 plan) and there shall be allowed as a deduction that
11 portion of amounts paid or accrued with respect to
12 which the requirements of paragraph (2) or (3) of this
13 subsection are satisfied if—
14 "(A) the benefits provided by the plan are
15 either required by foreign law or set forth in a
16 written document communicated to the active par-
17 ticipants;
18 "(B) in the case of a defined benefit plan, the
19 deduction is limited to amounts paid or accrued in
20 respect of benefits that are reasonably capable of
21 actuarial estimation;
22 (C) to the extent the amount taken into ac-
23 count is dependent upon actuarial determinations,
24 the actuarial cost method and assumptions used
25 are in the aggregate reasonable; and

1 "(D) the amount to be taken into account for
2 the taxable year is determined in a manner con-
3 sistent with generally accepted accounting princi-
4 ples in the United States applicable to the charg-
5 ing of pension costs against income.
6 "(2) FUNDED AMOUNT.—If an amount deter-
7 mined under paragraph (1) that has not been allowed
8 previously as a deduction is transferred to a separate
9 trust or fund (whether or not benefits to be provided
10 therefrom are subject to a substantial risk or forfeit-
11 ure), the requirements of this paragraph are satisfied—
12 "(A) if—
13 "(i) in the case of a defined benefit
14 plan—
15 "(I) the amount transferred and
16 any income earned thereon may not
17 revert to the employer or to the em-
18 ployer's benefit prior to the satisfaction
19 of all liabilities with respect to partici-
20 pants and beneficiaries under the plan;
21 and
22 "(II) the transferred amount does
23 not exceed the full funding limitation for
24 the year determined under section 412;
25 or

1 "(ii) in the case of a defined contribu-
2 tion plan—
3 "(I) the amount transferred and
4 any income earned thereon may not
5 revert to the employer or to the em-
6 ployer's benefit; and
7 "(II) the amount taken into ac-
8 count is allocated to individual accounts
9 of participants that will be adjusted at
10 least annually for the income and ex-
11 penses of the fund; and
12 "(B) if the amount taken into account is
13 transferred not later than the date described in
14 subsection (a)(6).
15 "(3) OTHER AMOUNTS.—To the extent an
16 amount determined under paragraph (1) does not satis-
17 fy the requirements of paragraph (2) and has not been
18 allowed previously as a deduction, the requirements of
19 this paragraph are satisfied if such amount—
20 "(A) at the time of the payment or accrual,
21 is paid or accrued in respect of benefits that are
22 not subject to a substantial risk of forfeiture; and
23 "(B) if accrued, represents the actuarial pres-
24 ent value of such accrued benefits.

1 "(4) DIRECT PAYMENTS.—A payment, which is
2 not subject to a substantial risk of forfeiture, to a par-
3 ticipant or beneficiary by an employer, shall be allowed
4 as a deduction to the extent not previously allowed as
5 a deduction under this subsection.

6 "(5) CARRYOVERS.—For purposes of this subsec-
7 tion, payments or accruals in any taxable year in
8 excess of the amount allowed as a deduction under this
9 subsection for such year (other than amounts not al-
10 lowed as a deduction due to the operation of paragraph
11 (6)), shall be treated as a payment or accrual in the
12 next succeeding taxable year.

13 "(6) LIMITATIONS.—The amount allowed as a
14 deduction under paragraph (1) shall not exceed the
15 amount allowed as a deduction without regard to this
16 paragraph multiplied by a fraction, the numerator of
17 which is the payments or accruals made on behalf of
18 active participants who are nonresident aliens, and the
19 denominator of which is the payments or accruals
20 made on behalf of all active participants. The preced-
21 ing sentence shall not apply if during the taxable
22 year—

23 "(A) at least 95 percent of all active partici-
24 pants are nonresident aliens, and

1 "(B) at least 95 percent of the contributions
2 made to or benefits accruing under the plan
3 during the taxable year in respect of active par-
4 ticipants are in respect of active participants who
5 are nonresident aliens.
6 "(7) ACCOUNTING METHOD.—Any change in the
7 method (but not the actuarial assumptions) used to de-
8 termine the amount allowed as a deduction under para-
9 graph (1) shall be treated as a change in accounting
10 method under section 446(e)."
11 (b) Section 312 of such Code (relating to effect on earn-
12 ings and profits) is amended by adding at the end thereof the
13 following new subsection:
14 "(l) EFFECT ON PLANS MAINTAINED FOR NONRESI-
15 DENT ALIENS.—For purposes of computing the earnings and
16 profits of a foreign corporation for any taxable year, the ex-
17 penses paid or accrued under a plan described in section
18 404(i) shall reduce the foreign corporation's earnings and
19 profits to the extent that such amounts would be deductible if
20 the provisions of section 404(i) were applicable to such for-
21 eign corporation for its taxable year."
22 (c) Section 964(a) of such Code is amended by inserting
23 "or 312(l)," after "section 312(k)(3)".
24 (d) Section 679(a)(1) of such Code is amended to read as
25 follows:

1 "(1) IN GENERAL.—A United States person who
2 directly or indirectly transfers property to a foreign
3 trust (other than a trust described in subsection (a) or
4 (i) of section 404) shall be treated as the owner for his
5 taxable year of the portion of such trust attributable to
6 such property if for such year there is a United States
7 beneficiary of any portion of such trust."

II

96TH CONGRESS
2D SESSION

S. 2805

To provide that Revenue Ruling 80-60 shall not require a change in the taxpayer's method of accounting for taxable years beginning before 1980.

IN THE SENATE OF THE UNITED STATES

JUNE 10 (legislative day, JANUARY 3), 1980

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

---

A BILL

To provide that Revenue Ruling 80-60 shall not require a change in the taxpayer's method of accounting for taxable years beginning before 1980.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) if a taxpayer would (but for this subsection) be re-
4 quired under Revenue Ruling 80-60 and Revenue Procedure
5 80-5 to change his method of accounting for his first taxable
6 year ending on or after December 25, 1979, such taxpayer
7 shall be required to make such change only for taxable years
8 beginning after December 31, 1979.

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1 (b) The consent granted by section 3.01 of Revenue
2 Procedure 80–5 shall also apply to a taxpayer's first taxable
3 year beginning after December 31, 1979.
4 (c) This section shall not apply to a taxpayer to whom
5 Revenue Procedure 80–5 does apply by reason of section
6 3.06 thereof..

II

96TH CONGRESS
2D SESSION

S. 2818

To amend the Internal Revenue Code of 1954 with respect to the treatment of mutual or cooperative electric and telephone companies.

IN THE SENATE OF THE UNITED STATES

JUNE 11 (legislative day, JANUARY 3), 1980

Mr. TALMADGE (for himself, Mr. BAUCUS, and Mr. PRYOR) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the treatment of mutual or cooperative electric and telephone companies.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) paragraph (12) of section 501(c) of the Internal Rev-
4 enue Code of 1954 (relating to list of exempt organizations)
5 is amended—
6 (1) by striking out "(12)" and inserting in lieu
7 thereof "(12)(A)",
8 (2) by striking out the second sentence, and

1 (3) by adding at the end thereof the following new
2 subparagraphs:
3 "(B) In the case of a mutual or cooperative
4 telephone company, subparagraph (A) shall be ap-
5 plied without taking into account any income re-
6 ceived or accrued—
7 "(i) from a nonmember telephone com-
8 pany for the performance of communication
9 services which involve members of the
10 mutual or cooperative telephone company,
11 "(ii) from qualified pole rentals, or
12 "(iii) from the sale of display listings in
13 a directory furnished to the members of the
14 mutual or cooperative telephone company.
15 "(C) In the case of a mutual or cooperative
16 electric company, subparagraph (A) shall be ap-
17 plied without taking into account any income re-
18 ceived or accrued from qualified pole rentals.
19 "(D) For purposes of this paragraph, the
20 term 'qualified pole rental' means any rental of a
21 pole (or other structure used to support wires)
22 if—
23 "(i) such pole (or other structure) is
24 used by the telephone or electric company in

1 providing telephone or electric services to its
2 members, and
3 "(ii) the use of such pole (or other
4 structure) pursuant to the rental is in con-
5 nection with the transmission by wire of
6 electricity or of telephone or other communi-
7 cations.
8 For purposes of the preceding sentence, the term
9 'rental' includes any sale of the right to use the pole
10 (or other structure)."
11 (b) The amendments made by subsection (a) shall apply
12 to all taxable years to which the Internal Revenue Code of
13 1954 applies.
14 SEC. 2. (a) Section 513 of the Internal Revenue Code of
15 1954 (defining unrelated trade or business) is amended by
16 adding at the end thereof the following new subsection:
17 "(g) CERTAIN POLE RENTALS.—In the case of a
18 mutual or cooperative telephone or electric company, the
19 term 'unrelated trade or business' does not include engaging
20 in qualified pole rentals (as defined in section 501(c)(12)(D))."
21 (b) The amendment made by subsection (a) shall apply
22 to taxable years beginning after December 31, 1969.

II

96TH CONGRESS
2D SESSION

S. 2904

To amend the Internal Revenue Code of 1954 to adjust the excise tax on tires, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JUNE 30 (legislative day, JUNE 12), 1980

Mr. TALMADGE (for himself and Mr. GLENN) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to adjust the excise tax on tires, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 SECTION 1. (a)(1) Section 4071(a)(1) of the Internal
4 Revenue Code of 1954 is amended by striking out "10
5 cents" and inserting "9.75 cents".
6 (2) Section 4071(a)(2) of such Code is amended by strik-
7 ing out "5 cents" and inserting "4.875 cents".
8 (3) Section 4071(d)(1) of such Code is amended by strik-
9 ing out "5 cents" and inserting "4.875 cents".

1 (b) The amendments made by this section shall apply on
2 and after January 1, 1981.
3 SEC. 2. (a) The determination of the extent to which
4 any overpayment of tax imposed by section 4071(a) (1) or (2)
5 or section 4071(b) of such Code arises by reason of an adjust-
6 ment of a tire after the original sale pursuant to a warranty
7 or guarantee, and the allowance of a credit or refund of any
8 such overpayment, shall be determined in accordance with
9 the principles set forth in regulations and rulings relating
10 thereto to the extent in effect on March 31, 1978.
11 (b) This section shall apply to the adjustment of any tire
12 after March 31, 1978, and prior to January 1, 1983.
13 SEC. 3. (a) Section 6416(b)(4) of such Code is amended
14 to read as follows:
15 "(4) TIRES AND INNER TUBES.—
16 "(A) If—
17 "(i) a tire or inner tube taxable under
18 section 4071 is sold by the manufacturer,
19 producer, or importer thereof on or in con-
20 nection with, or with the sale of, any other
21 article manufactured or produced by him,
22 and
23 "(ii) such other aritcle is an automobile
24 bus chassis or an automobile bus body, or is
25 by any person exported, sold to a State or

1 local government for the exclusive use of a
2 State or local government, sold to a non-
3 profit educational organization for its exclu-
4 sive use, or used or sold for use as supplies
5 for vessels or aircraft, any tax imposed by
6 chapter 32 in respect of such tire or inner
7 tube which has been paid by the manufactur-
8 er, producer, or importer thereof shall be
9 deemed to be an overpayment by him.
10 "(B) No credit or refund of any tax imposed
11 by section 4071(a) (1) or (2) or section 4071(b)
12 shall be allowed or made by reason of an adjust-
13 ment of a tire after the original sale and initial
14 use of such tire, pursuant to a warranty or guar-
15 antee.".
16 (b) The amendments made by this section shall apply to
17 the adjustments of any tire after December 31, 1982.

II

96TH CONGRESS
2D SESSION

S. 2967

To amend the Internal Revenue Code of 1954 to provide estate and gift tax equity for family enterprises, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JULY 24 (legislative day, JUNE 12), 1980

Mr. NELSON (for himself, Mr. BYRD of Virginia, Mr. WALLOP, and Mr. EAGLETON) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide estate and gift tax equity for family enterprises, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.**
4 (a) SHORT TITLE.—This Act may be cited as the
5 "Family Enterprise Estate and Gift Tax Equity Act".
6 (b) AMENDMENT OF 1954 CODE.—Except as otherwise
7 expressly provided, whenever in this Act an amendment or
8 repeal is expressed in terms of an amendment to, or repeal of,

1 a section or other provision, the reference shall be considered
2 to be made to a section or other provision of the Internal
3 Revenue Code of 1954.

4 **SEC. 2. INCREASE IN UNIFIED CREDIT.**

5 (a) CREDIT AGAINST ESTATE TAX.—
6 (1) IN GENERAL.—Subsection (a) of section 2010
7 (relating to unified credit against estate tax) is amend-
8 ed by striking out "$47,000" and inserting in lieu
9 thereof "$155,800".
10 (2) CONFORMING AMENDMENTS.—
11 (A) Subsection (b) of section 2010 is amend-
12 ed to read as follows:
13 "(b) PHASE-IN OF CREDIT.—

"In the case of decedents dying in:	"Subsection (a) shall be applied by substituting for '$155,800' the following amount:
1981	$47,000
1982	70,800
1983	96,300
1984	121,800.".

14 (B) Subsection (a) of section 6018 (relating
15 to estate tax returns by executors) is amended—
16 (i) by striking out "$175,000" in para-
17 graph (1) and inserting in lieu thereof
18 "$500,000"; and
19 (ii) by striking out paragraph (3) and in-
20 serting in lieu thereof the following:
21 "(3) PHASE-IN OF FILING REQUIREMENT
22 AMOUNT.—

"In the case of decedents dying in:	"Paragraph (1) shall be applied by substituting for '$500,000' the following amount:
1981	$175,000
1982	250,000
1983	325,000
1984	400,000.".

1 (b) CREDIT AGAINST GIFT TAX.—

2 (1) IN GENERAL.—Paragraph (1) of section
3 2505(a) (relating to unified credit against gift tax) is
4 amended by striking out "$47,000" and inserting in
5 lieu thereof "$155,800".

6 (2) CONFORMING AMENDMENT.—Subsection (b)
7 of section 2505 is amended to read as follows:

8 "(b) PHASE-IN OF CREDIT.—

"In the case of gifts made in:	"Subsection (a)(1) shall be applied by substituting for '$155,800' the following amount:
1981	$47,000
1982	70,800
1983	96,300
1984	121,800.".

9 (c) EFFECTIVE DATES.—The amendments made—

10 (1) by subsection (a) shall apply to the estates of
11 decedents dying after December 31, 1980, and

12 (2) by subsection (b) shall apply to gifts made
13 after such date.

14 **SEC. 3. UNLIMITED MARITAL DEDUCTION.**

15 (a) ESTATE TAX DEDUCTION.—

16 (1) IN GENERAL.—Section 2056 (relating to be-
17 quests, etc. to surviving spouses) is amended—

1 (A) by striking out subsection (c) and redes-
2 ignating subsection (d) as subsection (c); and
3 (B) by striking out "subsections (b) and (c)"
4 in subsection (a) and inserting in lieu thereof
5 "subsection (b)".
6 (2) CONFORMING AMENDMENT.—Paragraph (3) of
7 section 2057(e) (defining property passing from a dece-
8 dent) is amended by striking out "2056(d)" and insert-
9 ing in lieu thereof "2056(c)".
10 (b) GIFT TAX DEDUCTION.—
11 (1) IN GENERAL.—Subsection (a) of section 2523
12 (relating to gift to spouse) is amended to read as fol-
13 lows:
14 "(a) ALLOWANCE OF DEDUCTION.—Where a donor
15 who is a citizen or resident transfers during the calendar
16 quarter by gift an interest in property to a donee who at the
17 time of the gift is the donor's spouse, there shall be allowed
18 as a deduction in computing taxable gifts for the calendar
19 quarter an amount with respect to such interest equal to its
20 value.".
21 (2) TECHNICAL AMENDMENT.—Section 2523 is
22 amended by striking out subsection (f).
23 (c) EFFECTIVE DATES.—The amendments made—
24 (1) by subsection (a) shall apply to the estates of
25 decedents dying after December 31, 1981, and

1 (2) by subsection (b) shall apply to gifts made
2 after such date.

3 SEC. 4. INCREASE IN ANNUAL GIFT TAX EXCLUSION.

4 (a) IN GENERAL.—Subsection (b) of section 2503 (relat-
5 ing to exclusions from gifts) is amended by striking out
6 "$3,000" and inserting in lieu thereof "$6,000".

7 (b) EFFECTIVE DATE.—The amendment made by this
8 section shall apply to gifts made after December 31, 1981.

9 SEC. 5. VALUATION OF CERTAIN FARM, ETC., REAL
10 PROPERTY.

11 (a) DEFINITION OF QUALIFIED REAL PROPERTY.—
12 Subsection (b) of section 2032A (defining qualified real prop-
13 erty) is amended by adding at the end thereof the following
14 new paragraphs:

15 "(4) RETIRED AND DISABLED DECEDENTS.—

16 "(A) IN GENERAL.—If, on the date of death
17 of the decedent, the decedent did not otherwise
18 meet the requirements of paragraph (1)(C) with
19 respect to any property, and the decedent—

20 "(i) was eligible to receive old-age
21 benefits under title II of the Social Security
22 Act, or

23 "(ii) was disabled for a continuous
24 period ending on such date,

1 then paragraph (1)(C) shall be applied by substituting
2 'the date on which the decedent became eligible to re-
3 ceive old-age benefits under title II of the Social Secu-
4 rity Act or became disabled' for 'the date of the dece-
5 dent's death'.
6 "(B) DISABLED DEFINED.—For purposes of
7 subparagraph (A), an individual shall be disabled
8 if such individual has a mental or physical impair-
9 ment which renders him unable to materially par-
10 ticipate in the operation of the farm or other busi-
11 ness.
12 "(5) SPECIAL RULE FOR SPOUSES WHO ARE
13 QUALIFIED HEIRS.—In the case of any qualified real
14 property which was acquired by a qualified heir who is
15 the spouse of the decedent and which does not other-
16 wise meet the requirements of paragraph (1)(C) upon
17 the death of such spouse, such real property shall be
18 treated as meeting the requirements of paragraph
19 (1)(C) if such spouse was engaged in the active man-
20 agement of the operation of the business at all times
21 during—
22 "(A) the 10-year period ending on the date
23 of death of the spouse, or

1 "(B) the period beginning on the date of
2 death of the decedent and ending on the date of
3 death of the spouse.
4 "(6) SPECIAL RULE FOR CERTAIN WOOD-
5 LANDS.—In the case of real property used for a farm-
6 ing purpose described in subparagraph (C) of subsection
7 (e)(5) which does not otherwise meet the requirements
8 of paragraph (1)(C), such real property shall be treated
9 as meeting the requirements of paragraph (1)(C) if, at
10 all times during the 10-year period ending on the date
11 of the decedent's death—
12 "(A) such real property was owned by the
13 decedent or a member of the decedent's family
14 and used for such farming purpose, and
15 "(B) the decedent or a member of the dece-
16 dent's family was engaged in the active manage-
17 ment of the operation of the business.".
18 (b) DISPOSITIONS AND FAILURES TO USE FOR QUALI-
19 FIED USE.—
20 (1) 10-YEAR HOLDING PERIOD.—
21 (A) IN GENERAL.—Subsection (c) of section
22 2032A (relating to tax treatment of dispositions
23 and failures to use for qualified use) is amended—

1 (i) by striking out "15 years" in para-
2 graph (1) and inserting in lieu thereof "10
3 years", and
4 (ii) by striking out paragraph (3) and re-
5 designating paragraphs (4) through (7) as
6 paragraphs (3) through (6).
7 (B) CONFORMING AMENDMENTS.—Para-
8 graph (2) of section 2032A(h) (relating to treat-
9 ment of replaced property) is amended—
10 (i) by striking out in subparagraph (A)
11 all that follows "involuntarily converted,"
12 and inserting in lieu thereof the following:
13 "except that with respect to such qualified
14 replacement property the 10-year period
15 under paragraph (1) of subsection (c) shall be
16 extended by any period, beyond the 2-year
17 period referred to in section 1033(a)(2)(B)(i),
18 during which the qualified heir was allowed
19 to replace the qualified real property,", and
20 (ii) by striking out "(7)" in subpara-
21 graph (C) and inserting in lieu thereof "(6)".
22 (2) CESSATION OF QUALIFIED USE.—
23 (A) IN GENERAL.—Paragraph (6) of section
24 2032A(c) (defining cessation of qualified use), as

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1 redesignated by paragraph (1), is amended to read
2 as follows:
3 "(6) CESSATION OF QUALIFIED USE.—For pur-
4 poses of paragraph (1)(B)—
5 "(A) IN GENERAL.—Real property shall
6 cease to be used for the qualified use if—
7 "(i) such property ceases to be used for
8 the qualified use set forth in subparagraph
9 (A) or (B) of subsection (B)(2) under which
10 the property qualified under subsection (b), or
11 "(ii) except as provided in subparagraph
12 (B), during any period of 8 years ending
13 after the date of the decedent's death and
14 before the date of the death of the qualified
15 heir, there has been periods aggregating 3
16 years or more during which—
17 "(I) in the case of periods during
18 which the property was held by the de-
19 cedent (other than periods during which
20 the decedent was an individual de-
21 scribed in subsection (B)(4)(A) (i) or (ii)),
22 there was no material participation by
23 the decedent or any member of the
24 family in the operation of the farm or
25 other business, and

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1 "(II) in the case of periods during
2 which the property was held by any
3 qualified heir, there was no material
4 participation by such qualified heir or
5 any member of his family in the oper-
6 ation of the farm or other business.
7 "(B) 10-YEAR ACTIVE MANAGEMENT.—If
8 an eligible qualified heir elects, at such time and
9 in such manner as the Secretary may presecribe,
10 to have the provisions of this subparagraph apply
11 to any real property—
12 "(i) the provisions of clause (ii) of sub-
13 paragraph (A) shall not apply to such proper-
14 ty, and
15 "(ii) such property shall cease to be
16 used for the qualified use if the fiduciary or
17 the eligible qualified heir or any member of
18 his family did not take part in the active
19 management of the farm or other business at
20 all times during the period beginning on the
21 date of death of the decedent and ending on
22 the earlier of—
23 "(I) the date of death of the quali-
24 fied heir, or

1 "(II) the date which is 10 years
2 from date of death of the decedent.
3 "(C) ELIGIBLE QUALIFIED HEIR.—For pur-
4 poses of this paragraph, the term 'eligible quali-
5 fied heir' means—
6 "(i) any qualified heir with respect to
7 real property the qualified use for which is a
8 farming purpose described in subparagraph
9 (C) of subsection (e)(5), and
10 "(ii) in any other case, a qualified heir
11 who, on the date of death of the decedent—
12 "(I) is the spouse of the decedent,
13 "(II) has not attained the age of
14 21,
15 "(III) is a student described in
16 subparagraph (A) or (B) of section
17 151(e)(4), or
18 "(IV) was disabled (within the
19 meaning of subsection (b)(4)(B)) for a
20 continuous period ending on such
21 date.".
22 (B) CONFORMING AMENDMENT.—Subsection
23 (e) of section 2032A (relating to definitions and
24 special rules) is amended by adding at the end
25 thereof the following new paragraph:

1 "(12) ACTIVE MANAGEMENT.—The term 'active
2 management' means the making of the management
3 decisions of a business (other than the daily operating
4 decisions).".
5 (c) REPEAL OF $500,000 LIMITATION.—Subsection (a)
6 of section 2032A (relating to value based on use under which
7 property qualifies) is amended to read as follows:
8 "(a) VALUE BASED ON USE UNDER WHICH PROP-
9 ERTY QUALIFIES.—If—
10 "(1) the decedent was (at the time of his death) a
11 citizen or resident of the United States; and
12 "(2) the executor elects the application of this
13 section and files the agreement referred to in subsec-
14 tion (d)(2),
15 then, for purposes of this chapter, the value of qualified real
16 property shall be its value for the use under which it quali-
17 fies, under subsection (b), as qualified real property.".
18 (d) EXCHANGE OF QUALIFIED REAL PROPERTY.—
19 (1) IN GENERAL.—Section 2032A (relating to
20 valuation of certain farm, etc., real property) is amend-
21 ed by adding at the end thereof the following new sub-
22 section:
23 "(i) EXCHANGES OF QUALIFIED REAL PROPERTY.—
24 "(1) TREATMENT OF PROPERTY EXCHANGED.—

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1 "(A) IN GENERAL.—If an interest in quali-
2 fied real property is exchanged—
3 "(i) no tax shall be imposed by subsec-
4 tion (c) on such exchange if the interest in
5 qualified real property is exchanged solely
6 for an interest in qualified exchange property
7 in a transaction which qualifies under section
8 1031(a), or
9 "(ii) if clause (i) does not apply, the
10 amount of the tax imposed by subsection (c)
11 on such exchange shall be the amount deter-
12 mined under subparagraph (B).
13 "(B) AMOUNT OF TAX WHERE PROPERTY
14 RECEIVED IS NOT SOLELY AN INTEREST IN
15 QUALIFIED EXCHANGE PROPERTY.—The amount
16 determined under this subparagraph with respect
17 to any exchange is the amount of tax which (but
18 for this subsection) would have been imposed on
19 such exchange reduced by an amount equal to
20 that portion of such tax which is attributable to
21 the amount of the interest in qualified exchange
22 property received by the taxpayer.
23 "(2) TREATMENT OF QUALIFIED EXCHANGE
24 PROPERTY.—For purposes of subsection (c)—

1 "(A) any interest in qualified exchange prop-
2 erty shall be treated in the same manner as if it
3 were a portion of the interest in qualified real
4 property which was exchanged, and
5 "(B) any tax imposed by subsection (c) on
6 the exchange shall be treated as a tax imposed on
7 a partial disposition.
8 "(3) QUALIFIED EXCHANGE PROPERTY.—For
9 purposes of this subsection, the term 'qualified ex-
10 change property' means real property which is to be
11 used for the qualified use set forth in subparagraph (A)
12 or (B) of subsection (b)(2) under which the real prop-
13 erty exchanged therefor originally qualified under sub-
14 section (a).".
15 (2) CONFORMING AMENDMENTS.—
16 (A) Paragraph (1) of section 2032A(f) (relat-
17 ing to statute of limitations) is amended—
18 (i) by inserting "or exchange" after
19 "conversion",
20 (ii) by inserting "or (i)" after "(h)", and
21 (iii) by inserting "or of the exchange of
22 property" after "replace".
23 (B) Paragraph (2) of section 6324B(c) (relat-
24 ing to special liens) is amended by inserting "and
25 qualified exchange property (within the meaning

1 of section 2032A(i)(3))" before the period at the
2 end thereof.
3 (e) ELECTION REQUIREMENT OF SPECIAL RULES FOR
4 INVOLUNTARY CONVERSIONS REPEALED.—Section 2032A
5 (h) (relating to special rules for involuntary conversions of
6 qualified real property) is amended—
7 (1) by striking out "and the qualified heir makes
8 an election under this subsection" in paragraph (1)(A);
9 and
10 (2) by striking out paragraph (5).
11 (f) METHOD OF VALUING FARMS.—
12 (1) NET SHARE RENTALS.—
13 (A) IN GENERAL.—Paragraph (7) of section
14 2032A(e) (relating to method of valuing farms) is
15 amended by redesignating subparagraph (B) as
16 subparagraph (C) and by inserting after subpara-
17 graph (A) the following new subparagraph:
18 "(B) VALUE BASED ON NET SHARE RENTAL
19 IN CERTAIN CASES.—
20 "(i) IN GENERAL.—If there is no com-
21 parable land from which the average annual
22 gross rental may be determined, subpara-
23 graph (A)(i) shall be applied by substituting
24 'average net share rental' for 'average gross
25 cash rental'.

1 "(ii) NET SHARE RENTAL.—For pur-
2 poses of this paragraph, the term 'net share
3 rental' means the excess of—
4 "(I) the value of the produce re-
5 ceived by the lessor of the land on
6 which such produce is grown, over
7 "(II) the cash operating expenses
8 of growing such produce which, under
9 the lease, are paid by the lessor.
10 "(iii) DETERMINATION OF AVERAGE
11 NET SHARE RENTAL.—For purposes of this
12 subparagraph, the average net share rental
13 shall be—
14 "(I) the average net share rental
15 for reasonably comparable land pub-
16 lished by the Department of Agricul-
17 ture, an agency of the State in which
18 the land is located, or a college or uni-
19 versity of such State (within the mean-
20 ing of section 511(a)(2)(B)), or
21 "(II) if the average described in
22 subclause (I) is not available, the aver-
23 age net share rental determined on the
24 basis of comparable land located in the
25 locality of such farm.".

1 (B) CONFORMING AMENDMENTS.—
2 (i) Clause (i) of section 2032A(e)(7)(C)
3 (as redesignated by subsection (a)) is amend-
4 ed by inserting ", or where it is established
5 that the average net share rental is not capa-
6 ble of being determined under subparagraph
7 (B)(iii)" after "determined".
8 (ii) Subparagraph (A) of section 2032A
9 (e)(7) is amended by striking out "subpara-
10 graph (B)" and inserting in lieu thereof "sub-
11 paragraph (C)".
12 (2) COMPARABLE SALES.—Subparagraph (D) of
13 section 2032A(e)(8) (relating to method of valuing
14 closely held business interests, etc.) is amended by
15 striking out "Comparable" and inserting in lieu thereof
16 "Reasonably comparable".
17 (g) BASIS UPON RECAPTURE.—Paragraph (3) of sec-
18 tion 1014(a) (relating to basis of property acquired from a
19 decedent) is amended by inserting "(increased by the value of
20 any interest in such property (determined for purposes of this
21 chapter without regard to this section) with respect to which
22 an additional estate tax is imposed under section
23 2032A(C)(1))" after "section".

1 (h) EFFECTIVE DATE.—The amendments made by this
2 section shall apply to the estates of decedents dying after
3 December 31, 1981.

4 SEC. 6. ESTATE TAX TREATMENT OF TRANSFERS MADE
5 WITHIN 3 YEARS OF DECEDENT'S DEATH.

6 (a) IN GENERAL.—Section 2035 (relating to adjust-
7 ments for gifts made within 3 years of decedent's death) is
8 amended by adding the following new subsection at the end
9 thereof:
10 "(d) VALUATION OF GIFTS.—For purposes of subsec-
11 tion (a), the value of property included in the gross estate by
12 reason of subsection (a) shall be the value of such property at
13 the time of its transfer. The preceding sentence shall not
14 apply to a transfer of an interest in property which is in-
15 cluded in the value of the gross estate under section 2036,
16 2037, 2038, 2041, or 2042 or would have been included
17 under any of such sections if such interest had been retained
18 by the decedent.".
19 (b) EFFECTIVE DATE.—The amendments made by this
20 section shall apply to gifts made after December 31, 1980.

21 SEC. 7. ELECTION TO PAY GIFT TAX.

22 (a) IN GENERAL.—Section 2505 (relating to unified
23 credit against gift tax) is amended by adding at the end there-
24 of the following new subsection:
25 "(e) ELECTION TO PAY GIFT TAX.—

1 "(1) IN GENERAL.—An individual may elect with
2 respect to any calendar quarter not to have the credit
3 allowed by subsection (a) apply with respect to gifts
4 made during such quarter.
5 "(2) ELECTION.—Any election under paragraph
6 (1) shall be made at the same time as the return re-
7 quired to be filed for such quarter under section 6019
8 is filed and shall be in such form and manner as the
9 Secretary may by regulations prescribe.
10 "(3) EFFECTIVE OF ELECTION.—For purposes of
11 subsection (a)(2), the amount of any credit which does
12 not apply by reason of an election under paragraph (1)
13 shall not be treated as an amount allowable as a credit
14 under this section.".
15 (b) EFFECTIVE DATE.—The amendment made by sub-
16 section (a) shall apply to gifts made after December 31,
17 1980.
18 SEC. 8. COORDINATION OF EXTENSIONS OF TIME FOR PAY-
19 MENT OF ESTATE TAX WHERE ESTATE CON-
20 SISTS LARGELY OF INTEREST IN CLOSELY
21 HELD BUSINESS.
22 (a) ELIGIBILITY REQUIREMENTS.—Paragraph (1) of
23 section 6166(a) (relating to alternate extension of time for
24 payment of estate tax where estate consists largely of inter-
25 est in closely held business) is amended to read as follows:

1 "(1) IN GENERAL.—If the value of an interest in
2 a closely held business which is included in determin-
3 ing the gross estate of a decedent who was (at the date
4 of his death) a citizen or resident of the United States
5 exceeds—
6 "(A) 35 percent of the value of the gross
7 estate, or
8 "(B) 50 percent of the taxable estate, of such
9 decedent, the executor may elect to pay part or
10 all of the tax imposed by section 2001 in 2 or
11 more (but not exceeding 10) equal installments.".
12 (b) COORDINATION WITH SECTION 303.—
13 (1) IN GENERAL.—Subparagraph (A) of section
14 303(b)(2) (relating to relationship of stock to decedent's
15 estate) is amended by striking out all that follows
16 "gross estate" the first place it appears and inserting
17 in lieu thereof "exceeds—
18 "(i) 35 percent of the value of the gross
19 estate of the decedent, or
20 "(ii) 50 percent of the value of the tax-
21 able estate of the decedent.".
22 (2) CONFORMING AMENDMENT.—Subparagraph
23 (B) of section 303(b)(2) is amended to read as follows:
24 "(B) SPECIAL RULE FOR STOCK IN 2 OR
25 MORE CORPORATIONS.—For purposes of subpara-

1 graph (A), stock of 2 or more corporations, with
2 respect to each of which there is included in de-
3 termining the value of the decedent's gross estate
4 more than 20 percent in value of the outstanding
5 stock, shall be treated as the as the stock of a
6 single corporation. For purposes of the 20-percent
7 requirement of the preceding sentence, stock
8 which, at the decedent's death, represents the
9 surviving spouse's interest in property held by the
10 decedent and the surviving spouse as community
11 property or as joint tenants, tenants by the entire-
12 ty, or tenants in common shall be treated as
13 having been included in determining the value of
14 the decedent's gross estate.".
15 (c) Acceleration of Payment.—
16 (1) AMOUNT OF DISPOSITION.—Subparagraph (A)
17 of section 6166(g)(1) (relating to acceleration of pay-
18 ment in the case of disposition of interest or withdraw-
19 al of funds from a business) is amended by striking out
20 "one-third" each place it appears and inserting in lieu
21 thereof "50 percent".
22 (2) FAILURE TO PAY INSTALLMENT.—Paragraph
23 (3) of section 6166(g) (relating to failure to pay install-
24 ments) is amended to read as follows:
25 "(3) FAILURE TO PAY INSTALLMENT.—

1 (A) IN GENERAL.—If any installment under
2 this section is not paid on or before the date fixed
3 for its payment by this section (including any ex-
4 tension of time for the payment of such install-
5 ment), the unpaid portion of the tax payable in in-
6 stallments shall be paid upon notice and demand
7 from the Secretary.

8 "(B) PAYMENT WITHIN 6 MONTHS.—If any
9 installment under this section is not paid on or
10 before the date determined under subparagraph
11 (A) but is paid within 6 months of such date—

12 "(i) the provisions of subparagraph (A)
13 shall not apply with respect to such pay-
14 ment,

15 "(ii) the provisions of section 6601(j)
16 shall not apply with respect to the determi-
17 nation of interest on such payment, and

18 "(iii) there is imposed a penalty in an
19 amount equal to the product of—

20 "(I) 5 percent of the principal
21 amount of such payment, multiplied by

22 "(II) the number of months (or
23 fractions thereof) after such date and
24 before payment is made.

1 The penalty imposed under clause (iii) shall be
2 treated in the same manner as a penalty imposed
3 under subchapter B of chapter 68.".

4 (d) REPEAL OF SECTION 6166A.—Section 6166A (re-
5 lating to extension of time for payment of estate tax where
6 estate consists largely of interest in a closely held business) is
7 hereby repealed.

8 (e) TECHNICAL AMENDMENTS.—

9 (1) Sections 303(b)(1)(C), 2204(c), and 6161(a)(2)
10 are each amended by striking out "or 6166A" each
11 place it appears.

12 (2) Paragraph (2) of section 2011(c) is amended
13 by striking out "6161, 6166 or 6166A" and inserting
14 in lieu thereof "6161 or 6166".

15 (3) Subsections (a) and (b) of section 2204 are
16 each amended by striking out "6166 or 6166A" and
17 inserting in lieu thereof "or 6166".

18 (4) Subsection (b) of section 2621 is amended—

19 (A) by striking out "sections 6166 and
20 6166A (relating to extensions" and inserting in
21 lieu thereof "section 6166 (relating to extension",
22 and

23 (B) by strking out "Sections 6166 and
24 6166A" in the subsection heading and inserting in
25 lieu thereof "Section 6166".

1 (5)(A) Subsection (a) of section 6166 is amended
2 by striking out paragraph (4).
3 (B) The section heading for section 6166 is
4 amended by striking out "ALTERNATE".
5 (C) The table of sections for subchapter B of
6 chapter 62 is amended by striking out the items relat-
7 ing to sections 6166 and 6166A and inserting in lieu
8 thereof the following:

"Sec. 6166. Extension of time for payment of estate tax where estate consists largely of interest in closely held business.".

9 (6)(A) Subsections (a), (c)(2), and (e) of section
10 6324A are each amended by striking out "or 6166A"
11 each place it appears.
12 (B) Paragraphs (3) and (5) of section 6324A(d)
13 are each amended by striking out "or 6166A(h)".
14 (C) The section heading for section 6324A is
15 amended by striking out "OR 6166A".
16 (D) The table of sections for subchapter C of
17 chapter 64 is amended by striking out "or 6166A" in
18 the item relating to section 6324A.
19 (7) Subsection (d) of section 6503 is amended by
20 striking out "6163, 6166, or 6166A" and inserting in
21 lieu thereof "6163 or 6166".
22 (8) Subsection (a) of section 7403 is amended by
23 striking out "or 6166A(h)".

1 (f) EFFECTIVE DATE.—The amendments made by this
2 section shall apply to the estates of decedents dying after
3 December 31, 1980.

4 SEC. 9. DISCLAIMERS.

5 (a) IN GENERAL.—Subsection (c) of section 2518 (relat-
6 ing to disclaimers) is amended by adding at the end thereof
7 the following new paragraph:

8 "(3) DISCLAIMERS INEFFECTIVE UNDER STATE
9 LAW.—For purposes of subsection (b)(4), an interest
10 shall be treated as passing without any direction on the
11 part of the person making the disclaimer if—

12 "(A) the disclaimer meets the requirements
13 of paragraphs (1), (2), and (3) of subsection (b),

14 "(B) the disclaimer does not result in the
15 passing of the interest under the applicable State
16 law, and

17 "(C) the person transfers the interest to the
18 person to whom the interest would have passed
19 had the person making the disclaimer died before
20 the holder of legal title of such interest before the
21 last date on which the disclaimer must be re-
22 ceived under subsection (b)(2).".

23 (b) EFFECTIVE DATE.—The amendment made by sub-
24 section (a) shall apply to transfers creating an interest in the
25 person disclaiming made after December 31, 1980.

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II

96TH CONGRESS
2D SESSION

H. R. 7171

IN THE SENATE OF THE UNITED STATES

JUNE 18 (legislative day, JUNE 12), 1980

Read twice and referred to the Committee on Finance

AN ACT

To make certain miscellaneous changes in the tax laws.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. FEDERAL GRANTS FOR TUITION AND RELATED**
4 **EXPENSES AT INSTITUTIONS OF HIGHER EDU-**
5 **CATION NOT INCLUDIBLE IN GROSS INCOME**
6 **MERELY BECAUSE THE RECIPIENT IS**
7 **REQUIRED TO RENDER FUTURE SERVICE AS A**
8 **FEDERAL EMPLOYEE.**
9 (a) IN GENERAL.—Section 117 of the Internal Revenue
10 Code of 1954 (relating to scholarships and fellowship grants)

1 is amended by adding at the end thereof the following new
2 subsection:
3 "(c) FEDERAL GRANTS FOR TUITION AND RELATED
4 EXPENSES NOT INCLUDIBLE MERELY BECAUSE THERE IS
5 REQUIREMENT OF FUTURE SERVICE AS FEDERAL
6 EMPLOYEE.—
7 "(1) IN GENERAL.—If—
8 "(A) an amount received by an individual
9 under a Federal program would be excludable
10 under subsections (a) and (b) as a scholarship or
11 fellowship grant but for the fact that the indi-
12 vidual is required to perform future service as a
13 Federal employee, and
14 "(B) the individual establishes that, in
15 accordance with the terms of the grant, such
16 amount was used for qualified tuition and related
17 expenses,
18 gross income shall not include such amount.
19 "(2) QUALIFIED TUITION AND RELATED EX-
20 PENSES DEFINED.—For purposes of this subsection—
21 "(A) IN GENERAL.—The term 'qualified
22 tuition and related expenses' means—
23 "(i) tuition and fees required for the
24 enrollment or attendance of a student at an
25 institution of higher education, and

1 "(ii) fees, books, supplies, and equip-
2 ment required for courses of instruction at an
3 institution of higher education.
4 "(B) INSTITUTION OF HIGHER EDUCA-
5 TION.—The term 'institution of higher education'
6 means an educational institution in any State
7 which—
8 "(i) admits as regular students only
9 individuals having a certificate of graduation
10 from a high school, or the recognized equiva-
11 lent of such a certificate,
12 "(ii) is legally authorized within such
13 State to provide a program of education
14 beyond high school,
15 "(iii) provides an educational program
16 for which it awards a bachelor's or higher
17 degree, provides a program which is accept-
18 able for full credit toward such a degree, or
19 offers a program of training to prepare stu-
20 dents for gainful employment in a recognized
21 health profession, and
22 "(iv) is a public or other nonprofit insti-
23 tution.
24 "(3) SERVICE AS FEDERAL EMPLOYEE.—For
25 purposes of this subsection, service in a health man-

1 power shortage area shall be treated as service as a
2 Federal employee."
3 (b) EFFECTIVE DATE.—The amendment made by sub-
4 section (a) shall apply to taxable years beginning after De-
5 cember 31, 1980.

6 SEC. 2. ANNUITY CONTRACTS PURCHASED BY THE UNI-
7 FORMED SERVICES UNIVERSITY OF THE
8 HEALTH SCIENCES.

9 (a) IN GENERAL.—An annuity contract purchased by
10 the Uniformed Services University of the Health Sciences for
11 any employee who is a member of the civilian faculty or staff
12 of such university shall, for purposes of section 403(b) of the
13 Internal Revenue Code of 1954, be treated as an annuity
14 contract purchased for an employee by an employer described
15 in section 501(c)(3) of such Code which is exempt from tax
16 under section 501(a) of such Code.
17 (b) EFFECTIVE DATE.—Subsection (a) shall apply to
18 service after December 31, 1979, in taxable years ending
19 after such date.

20 SEC. 3. RETIREMENT-REPLACEMENT-BETTERMENT METHOD
21 OF DEPRECIATION.

22 (a) IN GENERAL.—Section 167 of the Internal Revenue
23 Code of 1954 (relating to allowance for depreciation) is
24 amended by redesignating subsection (r) as subsection (s) and
25 by inserting after subsection (q) the following new subsection:

1 "(r) RETIREMENT-REPLACEMENT-BETTERMENT
2 METHOD.—In the case of railroad track used by a common
3 carrier by railroad (including a railroad switching company or
4 a terminal company), the term 'reasonable allowance' as used
5 in subsection (a) includes an allowance for such track
6 computed under the retirement-replacement-betterment
7 method.".
8 (b) EFFECTIVE DATE.—The amendments made by sub-
9 section (a) shall apply with respect to taxable years ending
10 after December 31, 1953.
11 SEC. 4. TREATMENT OF CERTAIN RAILROAD STOCK FOR PUR-
12 POSES OF CONSOLIDATED RETURN REGULA-
13 TIONS.
14 (a) IN GENERAL.—For purposes of the consolidated
15 return regulations prescribed under section 1502 of the Inter-
16 nal Revenue Code of 1954, if the determination of whether
17 or not there has been a deemed disposition of stock in a
18 transferor railroad (as defined in section 374(c)(5)(B) of such
19 Code) depends on a determination of final value by the spe-
20 cial court under the Regional Rail Reorganization Act of
21 1973, that deemed disposition shall not be treated as occur-
22 ring before the earlier of—
23 (1) the date on which such determination becomes
24 final, or

1 (2) the first date on which there is an actual dis-
2 position of the stock or a deemed disposition not de-
3 scribed above.
4 (b) EFFECTIVE DATE.—Subsection (a) shall apply to
5 taxable years ending after March 31, 1976.

6 **SEC. 5. RESTORATION OF CERTAIN NET OPERATING LOSS**
7 **CARRYOVERS TO RAILROADS IN CONRAIL PRO-**
8 **CEEDINGS WHERE OTHER MEMBERS OF CON-**
9 **SOLIDATED GROUP HAD INCOME BECAUSE OF**
10 **STOCK DISPOSITION.**

11 (a) IN GENERAL.—For purposes of subsection (e) of
12 section 374 of the Internal Revenue Code of 1954 (relating
13 to use of expired net operating loss carryovers to offset
14 income arising from certain railroad reorganization proceed-
15 ings), if—
16 (1) subparagraphs (A) and (B) of paragraph (1) of
17 such subsection are satisfied with respect to a corpora-
18 tion,
19 (2) such corporation had a net operating loss for a
20 taxable year which would have satisfied the require-
21 ments of clause (i) of subparagraph (C) of such para-
22 graph (1) but for the fact that such net operating loss
23 was used to reduce the income of an affiliated group of
24 corporations which filed a consolidated return, and

1 (3) any portion of the amount so used was includ-
2 ed in an excess loss account which was required to be
3 restored to the income of a member or members of the
4 affiliated group,
5 then an amount equal to the restoration amount shall be
6 treated as meeting the requirements of subparagraph (C) of
7 such paragraph (1).
8 (b) RESTORATION AMOUNT DEFINED.—
9 (1) IN GENERAL.—For purposes of subsection (a),
10 the term "restoration amount" means, with respect to
11 the net operating loss for any taxable year, an amount
12 equal to the sum of—
13 (A) so much of the portion referred to in sub-
14 section (a)(3) as was required to be treated as or-
15 dinary income, and
16 (B) an amount equal to so much of such por-
17 tion as was required to be treated as long-term
18 capital gain, multiplied by the capital gain conver-
19 sion fraction.
20 (2) CAPITAL GAIN CONVERSION FRACTION.—For
21 purposes of paragraph (1), the capital gain conversion
22 fraction is a fraction—
23 (A) the numerator of which is the rate of tax
24 set forth in section 1201(a)(2) of such Code for

1 the taxable year the portion was required to be
2 included in income, and
3 (B) the denominator of which is the highest
4 rate of tax set forth in section 11(b) of such Code
5 for such taxable year.
6 (3) FIFO RULE FOR ADDITIONS TO EXCESS LOSS
7 ACCOUNT.—For purposes of this subsection, the
8 amount in any excess loss account at the time of resto-
9 ration (and the ordinary income portion of the restora-
10 tion) shall be treated as attributable to net operating
11 losses in the order of the years in which the respective
12 net operating losses arose.
13 (c) EFFECTIVE DATE.—This section shall apply to res-
14 torations occurring after March 31, 1976.
15 SEC. 6. PRESERVING EXISTING TAX STATUS OF WINE AND
16 FLAVORS USED IN THE PRODUCTION OF DIS-
17 TILLED SPIRITS.
18 (a) ALLOWANCE OF CREDIT.—Subpart A of part I of
19 subchapter A of chapter 51 of the Internal Revenue Code of
20 1954 (relating to distilled spirits) is amended by adding at the
21 end thereof the following new section:
22 "SEC. 5010. CREDIT FOR WINE CONTENT AND FOR FLAVORS
23 CONTENT.
24 "(a) ALLOWANCE OF CREDIT.—

1 "(1) WINE CONTENT.—On each proof gallon of
2 the wine content of distilled spirits, there shall be al-
3 lowed a credit against the tax imposed by section 5001
4 (or 7652) equal to the excess of—
5 "(A) $10.50, over
6 "(B) the rate of tax which would be imposed
7 on the wine under section 5041(b) but for its re-
8 moval to bonded premises.
9 "(2) FLAVORS CONTENT.—On each proof gallon
10 of the flavors content of distilled spirits, there shall be
11 allowed a credit against the tax imposed by section
12 5001 (or 7652) equal to $10.50.
13 "(3) FRACTIONAL PART OF PROOF GALLON.—In
14 the case of any fractional part of a proof gallon of the
15 wine content, or of the flavors content, of distilled spir-
16 its, a proportionate credit shall be allowed.
17 "(b) TIME FOR DETERMINING AND ALLOWING
18 CREDIT.—
19 "(1) IN GENERAL.—The credit allowable by sub-
20 section (a)—
21 "(A) shall be determined at the same time
22 the tax is determined under section 5006 (or
23 7652) on the distilled spirits containing the wine
24 or flavors, and

1 "(B) shall be allowable at the time the tax
2 imposed by section 5001 (or 7652) on such dis-
3 tilled spirits is payable as if the credit allowable
4 by this section constituted a reduction in the rate
5 of tax.
6 "(2) DETERMINATION OF CONTENT IN THE CASE
7 OF IMPORTS.—For purposes of this section, the wine
8 content, and the flavors content, of imported distilled
9 spirits shall be established by such chemical analysis,
10 certification, or other methods as may be set forth in
11 regulations prescribed by the Secretary.
12 "(c) DEFINITIONS.—For purposes of this section—
13 "(1) WINE CONTENT.—
14 "(A) IN GENERAL.—The term 'wine content'
15 means alcohol derived from wine.
16 "(B) WINE.—The term 'wine'—
17 "(i) means wine on which tax would be
18 imposed by paragraph (1), (2), or (3) of sec-
19 tion 5041(b) but for its removal to bonded
20 premises, and
21 "(ii) does not include any substance
22 which has been subject to distillation at a
23 distilled spirits plant after receipt in bond.
24 "(2) FLAVORS CONTENT.—

1 "(A) IN GENERAL.—Except as provided in
2 subparagraph (B), the term 'flavors content'
3 means alcohol derived from flavors of a type for
4 which drawback is allowable under section 5134.
5 "(B) EXCEPTIONS.—The term 'flavors con-
6 tent' does not include—
7 "(i) alcohol derived from flavors made
8 at a distilled spirits plant, and
9 "(ii) in the case of any distilled spirits
10 product, alcohol derived from flavors to the
11 extent such alcohol exceeds (on a proof
12 gallon basis) 2½ percent of the finished
13 product."
14 (b) CLERICAL AMENDMENT.—The table of sections for
15 such subpart A of part I of subchapter A of chapter 51 of
16 such Code is amended by adding at the end thereof the fol-
17 lowing new item:

"Sec. 5010. Credit for wine content and for flavors content."

18 (c) EFFECTIVE DATE.—The amendments made by sub-
19 sections (a) and (b) shall take effect on January 1, 1980.

Passed the House of Representatives June 17, 1980.

Attest: EDMUND L. HENSHAW, JR.,

Clerk.

By THOMAS E. LADD,

Assistant to the Clerk.

INTRODUCTION

This pamphlet provides a description of S. 2967, relating to estate and gift taxes, scheduled for a public hearing on August 4, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally.

For each provision of the bill, the pamphlet contains a discussion of present law, the issues involved, an explanation of the provision, and the effective date. The estimated revenue effect for the bill is also contained in a table presented at the end of the pamphlet.

DESCRIPTION OF THE BILL

I. Unified Credit for Estate and Gift Taxes (sec. 2 of the bill and secs. 2010, 2505, and 6018 of the Code)

Present law

Prior to the Tax Reform Act of 1976, there was a $30,000 lifetime exemption for gift tax purposes and a $60,000 exemption for estate tax purposes.[1] The Tax Reform Act of 1976 combined the separate estate and gift tax rates into a unified transfer tax system. In addition, the 1976 Act converted the prior estate and gift tax exemptions into a unified credit. With the unified credit, the gift or estate tax is first computed without any exemption and then the unified credit is subtracted to determine the amount of gift or estate tax payable before the allowance of other credits.

The amount of the unified credit when fully phased in is $47,000.[2] With a unified credit of $47,000, there is no estate or gift tax on transfers of up to $175,625. Under the 1976 Act, the unified credit against the estate tax is phased in as follows:

Estates of decedents dying in—	Unified credit	Estate tax filing requirement based on gross estate [3]
1977	$30,000	$120,000
1978	34,000	134,000
1979	38,000	147,000
1980	42,500	161,000
1981 and thereafter	47,000	175,000

[3] Under the unified estate and gift tax system adopted under the 1976 Act, the gross estate filing requirement amount is reduced by taxable gifts made after 1976.

The amount of the unified credit for gift tax purposes is increased in the same manner.

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[1] Subject to death tax conventions concluded with foreign countries, an estate tax exemption of $30,000 was provided for estates of nonresident aliens. Special rules were also provided for estates of residents of possessions of the United States.

[2] For estates of nonresident aliens, the unified credit is $3,600 (Code sec. 2102(c)(1)). Special rules are provided for the estates of residents of possessions of the United States (Code sec. 2102(c)(2)) and estates of decedents who had been expatriated to avoid tax (Code sec. 2107(c)).

Issue

The issue is whether the amount of the unified estate and gift tax credit should be increased.

Explanation of provision

Under the bill, the unified credit would be increased over a 4-year period beginning in 1982 to $155,800. With a unified credit of this amount, there would be no estate or gift tax on transfers of up to $500,000.

The increase in the unified credit against the estate tax would be phased in as follows:

Estates of decedents dying in—	Unified credit	Estate tax filing requirement based on gross estate [3]
1982	$70, 800	$250, 000
1983	96, 300	325, 000
1984	121, 800	400, 000
1985 and thereafter	155, 800	500, 000

[3] Under the unified estate and gift tax system adopted under the 1976 Act, the gross estate filing requirement amount is reduced by taxable gifts made after 1976.

The amount of the unified credit for gift tax purposes would be increased in the same manner.

The provision would not increase the unified credit with respect to estates of nonresident aliens, residents of possessions of the United States, or decedents who had expatriated to avoid tax.

Effective date

Under this provision, the increases in the unified credit would apply beginning with respect to gifts made, or decedents dying, after December 31, 1981.

II. Marital Deduction (sec. 3 of the bill and secs. 2056 and 2523 of the Code)

Present law

Under present law, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first $100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal lifetime transfers in excess of $200,000.

In addition, an estate tax marital deduction is allowed for the value of property passing from a decedent to the surviving spouse for the greater of $250,000 or one-half of the decedent's adjusted gross estate. This amount is adjusted by the excess of the amount of unlimited marital gift tax deduction over one-half of the lifetime gifts to the surviving spouse.

Under these provisions, transfers of community property or terminable interests generally do not qualify for either the gift or estate tax marital deduction.

Issue

The issue is whether an unlimited marital deduction should be allowed for both gift and estate tax purposes.

Explanation of provision

The bill would provide an unlimited marital deduction for both estate and gift tax purposes. The bill would not change the present law rule that transfers of terminable interests do not qualify for the marital deduction.

Effective date

This provision would be effective for decedents dying after December 31, 1981, in the case of the estate tax marital deduction, and for gifts made after December 31, 1981, in the case of the gift tax marital deduction.

III. Annual Gift Tax Exclusion (sec. 4 of the bill and sec. 2503(b) of the Code)

Present law

Under present law, an annual exclusion of $3,000 per donee is allowed with respect to gifts of present interests in property (Code sec. 2503(b)). For example, an individual may give five different individuals $3,000 each in cash and owe no gift tax.

The annual exclusion has equalled $3,000 since January 1, 1943. When the gift tax was first enacted under the Revenue Act of 1932, the amount of the annual exclusion was $5,000. The annual exclusion was reduced to $4,000 in 1938 and was then further reduced to its present $3,000 amount under the Revenue Act of 1942.

The annual exclusion serves to eliminate gifts of small value from the gift tax system. Thus, the principal rationale for the exclusion is based on administrative and taxpayer compliance concerns. However, it is sometimes contended that the annual exclusion operates to some extent as an incentive for transfers of wealth from older to younger generations.

A gift made by a husband or wife may, with the consent of both, be treated for gift tax purposes as made one-half by each (Code sec. 2513). The full annual exclusion is allowed with respect to each spouse's one-half share of gifts of present interests in property. Thus, in these cases, a donor may make up to $6,000 in excludable transfers to a donee during a calendar year.

Issue

The principal issue is whether the annual gift tax exclusion should be increased. If it is appropriate to increase the annual exclusion, the next issue concerns the amount to which it should be increased. Another issue is whether a special exclusion should be provided for certain consumption-type transfers when the payor is not legally obligated to support the beneficiary, e.g., voluntary payments of a relative's medical and educational expenses.

Explanation of provision

Under the bill, the gift tax annual exclusion would be increased to $6,000 per donee.

Effective date

The provision would apply to gifts made after December 31, 1981.

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IV. Special Valuation of Farm or Other Business Real Property (sec. 5 of the bill and secs. 2032A and 1014 of the Code)

Present law

For estate tax purposes, real property must ordinarily be valued at its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value rather than full fair market value, provided that the gross estate may not be reduced more than $500,000 (Code sec. 2032A).

To qualify for current use valuation: (1) the decedent must have been a citizen or resident of the United States at his death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property), must be at least 50 percent of the decedent's gross estate (reduced by debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate must be qualified farm or closely held business real property;[1] (4) the real property qualifying for current use valuation must pass to a qualified heir;[2] (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely held business for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death (Code secs. 2034A (a) and (b)).[3]

The current use value of all qualified real property may be determined under the multiple factor method (Code sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate (for example, comparable sales) and any other factors that fairly value the property.

If there is comparable land from which the average annual gross cash rental may be determined, then farm property may also be valued

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[1] For purposes of the 50 percent and 25 percent tests, the value of property is determined without regard to its current use value.

[2] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[3] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

under the formula method (Code sec. 2032A(e)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting the average annual State and local real estate taxes for the comparable land from the average annual gross cash rental for comparable land used for farming, and (2) dividing that amount by the average annual effective interest for all new Federal Land Bank loans.[4]

On July 19, 1978, the Department of the Treasury issued proposed regulations describing the circumstances under which current use valuation would be available and defining gross cash rental under section 2032A. Under the proposed regulations, the current use value was to be available only if there were some nonfarm use for the property. The proposed regulations also provided that if no comparable farm property had been leased on a cash basis, then the formula method could be applied by converting crop share rentals into cash rentals. If the crops were sold for cash in a qualified transaction, the selling price would be considered the gross cash rental. If no qualified sale occurred, then the gross cash rental would equal the cash value of the crops on the date received on an established public agricultural commodities market.

On September 10, 1979, the Department of the Treasury withdrew the proposed definition of gross cash rental and published another proposed regulation defining gross cash rental.[5] The new proposed regulation provides that crop share rentals may not be used under the formula method. Consequently, under the proposed regulation, if no comparable land is rented solely for cash, the formula method may not be used and the qualified farm property may be valued only by the multiple factor method. The Internal Revenue Service also issued on that date a news release indicating that current use value would be available with respect to any real property which satisfied the requirements of section 2032A, even if there were no other highest and best use for the property.

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation will be recaptured. A "cessation of qualified use" occurs if (1) the qualified property ceases to be used for the qualified use under which the property qualified for current use valuation or (2) during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there have been periods aggregating 3 years or more during which there was no material participation by the qualified heir or a member of his family in the operation of the farm or other business (Code sec. 2032A(c)(7)).

The recapture provisions apply not only where the qualified real property is sold (or exchanged in a taxable transaction) to nonfamily members, but also where the property is disposed of to nonfamily members in a tax-free exchange, for example, a like-kind exchange under section 1031. If, however, an involuntary conversion of qualified real property occurs and the cost of qualified replacement property equals

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[4] Each average annual computation must be made on the basis of the five most recent calendar years ending before the decedent's death.

[5] 44 Fed. Reg. 52,696 (1979).

or exceeds the amount realized on the conversion, then, in general, the adjusted tax difference will not be recaptured as a result of the involuntary conversion (Code sec. 2032A(h)). Under present law, the special rules for involuntary conversions apply only if the qualified heir makes an election in accordance with section 2032A(h)(5).

The maximum amount subject to recapture, the "adjusted tax difference," is the excess of (1) the estate tax liability which would have been incurred had the current use valuation provision not been utilized over (2) the estate tax liability based on the current use valuation provisions (Code sec. 2032A(c)(2)). In general, if a recapture event occurs within 10 years of the decedent's death, the amount of the additional or "recapture" tax imposed with respect to the interest shall be an amount equal to the lesser of (1) the adjusted tax difference attributable to this interest or (2) the excess of the amount realized with respect to the interest over the value of the interest determined with the current use valuation.[6] If the recapture event occurs more than 10, but less than 15, years after the decedent's death (but prior to the death of the qualified heir), the amount subject to recapture is reduced on a monthly basis (Code sec. 2032A(c)(3)).

Under present law, where special use valuation is elected, the basis of the property in the hands of the estate or qualified heir is the special use value, instead of its full fair market value (Code sec. 1014(a)(3)).

Issues

The issues presented by this section of the bill include the following:

(1) Whether relief from the material participation requirement should be given where the decedent was retired or disabled.

(2) Whether special valuation should be made available to property which was not owned and used as a farm by the decedent for a substantial period before his death where the surviving spouse actively manages the property after the death of the decedent.

(3) Whether a less restrictive standard of involvement by the decedent in the operation of the land prior to his death should apply in the case of woodlands.

(4) Whether the estate tax benefit recapture period under section 2032A should be reduced from 15 years to 10 years.

(5) Whether the recapture of tax benefit can be avoided by having an agent of the qualified heir actively manage the property where the property is used for farm purposes or, in all other cases, where the qualified heir is a spouse, a minor, a student, or disabled.

(6) Whether the $500,000 limitation on the reduction of the value of the decedent's gross estate under section 2032A(a)(2) should be repealed.

(7) Whether certain like-kind exchanges should not trigger recapture of estate tax benefits under section 2032A, or trigger the recapture of only a proportionate amount of the estate tax benefits.

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[6] In cases where there is a cessation of qualifying use or a sale or exchange at other than arm's length, the amount of the additional tax imposed will be the lesser of (1) the adjusted tax difference attributable to the interest or (2) the excess of the fair market value of the interest over the current use valuation.

(8) Whether an election should be required to secure the benefits of the special rules for involuntary conversions in section 2032A(h).

(9) Whether qualified farm property may be valued under the formula method in section 2032A(e)(7)(A) by converting net crop share rents to cash if no comparable land is leased solely for cash and comparable land is leased partially or completely on a crop share basis.

(10) Whether the basis of property with respect to which there has been recapture of the estate tax benefits should be increased to its fair market value on the date of the decedent's death.

Explanation of provision

This provision would make several modificaions to the rules relating to the special valuation of farm and other business real property for estate tax purposes.

First, the bill would provide that the material paricipaion requirement for qualification for special use valuation need only be met until the date upon which the decedent retires or becomes disabled.

Second, the bill would provide an "active management" qualification test, rather than a material participation test, with respect to farm or other business real property included in the gross estate if the property had been inherited from a spouse and had qualified for special valuation in that spouse's estate. "Active management" is defined to mean the making of the management decisions of a business, other than the daily operating decisions.

Third, in the case of woodlands, the bill would provide that qualification for special valuation can be attained if the decedent or a member of his family is engaged in the "active management" of the woodlands for the 10-year period prior to his death.

Fourth, the period during which the adjusted tax difference could be recaptured would be reduced from 15 years to 10 years. The current rules applicable after the tenth year would be repealed.

Fifth, the bill would provide that recapture of the tax benefits would not occur where an agent of the qualified heir engages in the active mangement of the property in the case of all farming property or where the qualified heir was a surviving spouse of the decedent, a minor, a student or is disabled in the case of other property.

Sixth, the $500,000 limit on the reduction of the decedent's gross estate would be repealed. Consequently, the current use value, computed under section 2032A, would be substituted on the estate tax return for the full fair market value.

Seventh, the bill would expressly provide that an exchange pursuant to section 1031 of the qualified real property solely for real property to be used for the same qualified use as the original qualified real property would not trigger a recapture of the adjusted tax difference. If however, the like-kind exchange under section 1031 were not entirely for qualified property, then a proportionate amount of the recapture tax would be payable.

Eighth, a qualified heir would not be required to make an election to secure the benefits of the special rules for involuntary conversions.

Ninth, the bill would amend section 2032A to provide that if there is no comparable land from which to determine the average annual gross cash rental, then the average net share rental could be substituted

for the average gross cash rental in applying the formula method. The net share rental would be (1) the value of the produce grown on the leased land received by the lessor, reduced by (2) the cash operating expenses of growing the produce that are paid, under the terms of the lease, by the lessor.

Finally, the bill would provide that, upon the recapture of the estate tax-benefits, the basis of the property would be increased to its fair market value on the date of the decedent's death.[7]

Effective date

This provision would be effective for estates of decedents dying after December 31, 1981.

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[7] Technical modifications would be necessary to the bill to clarify that the basis is stepped up to its value as of the decedent's death and to insure that the special use value is not double counted in determining basis.

V. Estate Tax Treatment of Transfers Made Within Three Years of Death (sec. 6 of the bill and sec. 2035 of the Code)

Present law

Under present law, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether the gifts were actually made in contemplation of death. However, an exception to this rule applies for transfers of property (other than a transfer with respect to a life insurance policy) where no gift tax return was required to be filed with respect to the gift.

When a gift made within three years of the decedent's death is required to be included in the decedent's gross estate, it is valued at the time of the decedent's death. However, a credit is allowed against the estate tax for any gift tax paid by the decedent on the gift. Generally, the net effect of these two rules is to include in the gross estate the appreciation in value of the property from the date of the gift until the date of death.

There are several provisions of the Code which depend upon the amount of the decedent's gross estate. For example, qualification for special tax treatment in valuing farm real property (Code sec. 2032A), redemptions of stock of closely held corporations (Code sec. 303), and installment payment of the estate tax attributable to a closely held business interest (Code secs. 6166 and 6166A) depend upon the size of the gross estate. Consequently, the amount of gifts includible in a decedent's gross estate as gifts made within 3 years of death can affect the application of these other provisions.

Issue

The issue is whether post-gift appreciation of gifts made within three years of death should be excluded from the gross estate.

Explanation of provision

The bill would provide that the value of gifts which are includible in the gross estate by reason of being made within three years of death is to be their value on the date of gift instead of their value at the date of death. The estate will continue to receive a credit for any gift taxes imposed on the gift. Thus, the net effect of the bill would be to subject the gift to the gift tax at its value at the time of gift and to exclude any appreciation in value from the date of gift to the date of death from the estate tax. The value of the gift at the date of gift would still be included in the gross estate for purposes of determining the applicability of those other provisions (such as Code secs. 303, 2032A, 6166, and 6166A) which depend upon the amount of the decedent's gross estate.

Effective date

This provision would be effective for gifts made atfer December 31, 1980.

VI. Election to Pay Gift Tax (sec. 7 of the bill and sec. 2505 of the Code)

Present law

Under present law, any unused portion of the unified credit must be used to reduce the gift tax payable for taxable gifts made during a taxable period (Code sec. 2505(a)). Thus, a donor cannot elect not to use a portion of the unified credit that is otherwise allowable.[1]

The consequences of requiring the use of the unified credit against the gift tax, rather than using it on an elective basis, relate to finalizing the valuation of gifts made for preceding calendar years and quarters. Under present law, the valuation used for a gift made in a taxable period closed by the period of limitations for assessing deficiencies is fixed only if a gift tax has been assessed or paid for the taxable period in which the gift was made (Code sec. 2504(c)). Thus, in cases where the unified credit eliminates tax liability for a taxable period, the valuation of a gift made in an otherwise closed taxable period might be challenged on audit in subsequent taxable periods. Although no gift tax deficiency may be assessed for the prior taxable period, an increase in the valuation of the prior gift may push the taxable gifts for the subsequent taxable periods into a higher tax bracket under the progressive rate structure.

Issue

The issue is whether use of the unified credit for gift tax purposes should be elective.

Explanation of provision

Under the bill, a donor could elect to have all or any portion of the unified credit apply. The election would be required to be made no later than the due date for the return to which the election applies and in the form and manner prescribed under regulations.

Effective date

This provision would apply to gifts made after December 31, 1980.

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[1] Under prior law, any unused portion of the gift tax specific exemption could be claimed for any taxable period the donor wished (Code sec. 2521 as in effect before repeal by the Tax Reform Act of 1976).

VII. Installment Payment of Estate Tax Attributable to Closely Held Business Interests (sec. 8 of the bill and secs. 6166 and 6166A of the Code)

Present law

Code section 6166, as added by the Tax Reform Act of 1976, provides a 15-year period for the payment of the estate tax attributable to a decedent's interest in a closely held business (including a farm). Under this provision, an executor may elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first 5 years is payable annually. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 annual installments. A special 4 percent interest rate is allowed on the estate tax attributable to the first $1 million of closely held business property, and interest on amounts of estate tax in excess of this amount is at the regular rate for interest on deferred payments (currently 12 percent).

In order to qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) included in the decedent's estate must exceed 65 percent of the value of the gross estate reduced by allowable expenses, indebtedness, and losses. For this purpose, the term "interest in a closely held business" means an interest as sole proprietor in a trade or business; an interest as a partner in a partnership having not more than 15 partners, or in which the decedent owned 20 percent or more of the capital; or ownership of stock in a corporation having not more than 15 shareholders, or in which the decedent owned 20 percent or more in value of the voting stock. Certain interests held by the decedent's family are treated as held by one shareholder or partner.

If a decedent's gross estate includes more than 20 percent of the value of each of two or more closely held businesses, the businesses can be treated as a single closely held business in determining whether the 65 percent test is satisfied.

Under present law, the privilege of making installment payments of the estate tax terminates if one-third or more of the value of the business is withdrawn (other than in certain redemptions for the payment of the estate tax), or if there is disposition of one-third or more of the value of decedent's interest in the business. In addition, all payments are accelerated if there is a failure to timely pay any installment payment.

A 10-year extended payment provision is also provided for estate tax attributable to a closely held business where a lesser proportion of the estate is represented by its value (Code sec. 6166A). Under this 10-year extension, the value of the business must be in excess of either 35 percent of the value of the gross estate or 50 percent of the taxable estate. Under this provision, acceleration of payments occurs if 50

percent or more of the value of the business is withdrawn, or if there is a disposition of 50 percent or more of the value of the decedent's interest in the busness. In addition, the Internal Revenue Service is authorized to permit discretionary annual extensions of up to 10 years to pay estate tax if reasonable cause for an extension exists (Code sec. 6161(a)(2)). Under both of the extensions, interest is payable at the regular rate rather than the special 4-percent rate.

Under the income tax law (Code sec. 303), a qualified redemption of stock to pay estate taxes funeral and administration expenses will be taxed as capital gain rather than as a dividend distribution taxed as ordinary income, even though a similar redemption would have been treated as a dividend if the stock had been redeemed during the decedent's lifetime. To qualify for this treatment under present law, the value of the stock redeemed, plus the value of the other stock of the redeeming corporation includible in the estate, must be more than 50 percent of the value of the gross estate reduced by allowable expenses, indebtedness and losses. Corporations, more than 75 percent of the value of which are included in the decedent's estate, may be aggregated in order to meet the 50 percent requirement.

Issues

The issue generally is whether the provisions for the deferral of estate tax payments and redemption of stock to pay the estate tax should be more closely coordinated. This includes whether a uniform set of eligibility requirements should be provided as well as a single rule for payment periods, interest rates and acceleration of payments.

Explanation of provision

Under the bill, the provision of present law allowing for the payment of estate taxes over a 15-year period would be expanded to include all estates in which the value of a closely held business (or businesses) included in the decedent's estate exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate. Also, the provision relating to the qualified redemption of stock to pay the estate tax would apply if the value of the closely held business met the same test. Likewise, the rules for aggregating two or more businesses for determining qualified redemptions would be the same as the present aggregation test for deferred payments.

The rules relating to acceleration of payments would be changed to increase from one-third to 50 percent the amount of a business interest that could be disposed of or withdrawn before payments would be accelerated. Also, a late payment made within 6 months of the due date would no longer accelerate all payments. Instead, there would be imposed a penalty of 5 percent per month on the amount of the payment, and interest on the payment would be payable at the regular interest rate.

The bill also would repeal the present 10-year estate tax extension under Code section 6166A.

Effective date

The provision would apply to estates of decedents dying after December 31, 1980.

VIII. Disclaimers (sec. 9 of the bill and sec. 2518 of the Code)

Present law

Under present law, a disclaimer is effective for federal transfer tax purposes if the requirements of Code section 2518 are satisfied. If a qualified disclaimer is made, the federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer.

A qualified disclaimer is an irrevocable and unqualified refusal to accept an interest in property that satisfies four requirements. First, the refusal must be in writing. Second, the written refusal must be received by the transferor of the interest, his legal representative, or the holder of the legal title to the property not later than 9 months after the day on which the transfer creating the interest is made. Nevertheless, the period for making the disclaimer is not to expire in any case until 9 months after the day on which the disclaimant has attained age 21. Third, the disclaimant must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass, as a result of the refusal to accept the property, to the surviving spouse or a person other than the disclaimant. The disclaimant cannot have the authority to direct the redistribution or transfer of the property to another person.

Proposed Regulations issued on July 21, 1980, state that a disclaimer satisfies the requirements of Code section 2518 only if the disclaimer is effective under applicable local law to divest ownership of the disclaimed property in the disclaimant and to vest it in another.

Issue

The issue is whether the validity of a disclaimer for Federal tax purposes should be conditioned upon its validity under local laws.

Explanation of provision

Under the bill, a disclaimer that does not result in the passing of the interest under local law would still be a qualified disclaimer for Federal tax purposes if certain additional requirements are met. Specifically, the disclaimant, within the present time limits for making a qualified disclaimer, would be required to transfer the property interest to the person who would have received the property interest if the disclaimant had predeceased the holder of legal title to the property.

Effective date

This provision of the bill would be effective with respect to transfers creating an interest in the person disclaiming made after December 31, 1980.

REVENUE EFFECT

Table 1—Estate and Gift Tax Reduction of S. 2967

[In millions of dollars; fiscal years]

	1982	1983	1984	1985
Unified credit for estate and gift taxes		1,231	2,173	3,015
Marital deduction [1]		39	29	25
Annual gift tax exclusion [1]	65	60	60	60
Special valuation of farm or other business real-property [1]		155	155	155
Estate tax treatment of transfers made within 3 years of death [1]	33	37	42	46
Election to pay gift tax	(2)	(2)	(2)	(2)
Installment payment of estate tax attributable to closely held business interests [1]	13	13	13	13
Disclaimers	(2)	(2)	(2)	(2)
Total reduction	111	1,535	2,472	3,314

[1] Additional loss after enactment of the unified credit proposal.
[2] Less than $5 million.

Supplement to the

Description of Miscellaneous Tax Bills

Listed for a Hearing

Before the

Subcommittee on Taxation and
Debt Management Generally

of the

Committee on Finance

on August 4, 1980

S. 2938--Senators Dole, Baucus, Cochran, Ford,
Hatch, Mathias, Moynihan, and Wallop

Income Tax Exclusion for Certain Federal Scholarship
Grants

The bill, S. 2938, contains provisions which are identical to those contained in section 1 of H.R. 7171 which is scheduled for the public hearing on August 4, 1980.

In addition, S. 2938 would extend the temporary exclusion under present law for one year for National Research Service Awards. As extended, tax-exempt scholarship treatment would apply through calendar year 1981.

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on August 4, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. The are four Senate bills and three sections of a House-passed bill (H.R. 7171) described in the pamphlet.

The first part of the pamphlet is a summary of the bills presented in bill numerical order for Senate bills and then for the sections of the House-passed bill. This is followed by a more detailed description of the bills, setting forth present law, the issues involved, an explanation of the bills, the effective dates, and the estimated revenue effects.

I. SUMMARY OF BILLS

A. SENATE BILLS

1. S. 2775—Senators Bentsen, Talmadge, Moynihan, Baucus, Dole, Chafee, and Wallop

Nonqualified Deferred Compensation Plans for Nonresident Aliens

The bill would provide special rules for nonqualified plans of deferred compensation primarily for the benefit of persons substantially all of whom are nonresident aliens. These provisions would govern the allowability of deductions with respect to the plans and the effect of the plans on a corporation's earnings and profits. Also, trusts under the plans would be exempted from certain rules relating to foreign trusts with U.S. beneficiaries.

2. S. 2805—Senator Nelson

Deferred Application of Revenue Procedure 80–5 and Revenue Ruling 80–60 Relating to Inventory Writedowns

Revenue Procedure 80–5 and Revenue Ruling 80–60 require taxpayers to conform their method of inventory accounting to that method of inventory accounting approved by the Supreme Court in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979). For taxpayers with excess inventories (inventories in excess of foreseeable demand) that have been erroneously written down for tax purposes, these pronouncements require that the writedowns be taken back into income.

The Internal Revenue Service pronouncements were issued on February 8, 1980, and are applicable to 1979 taxable years. Taxpayers contend that by waiting until 1980 to release the pronouncements, the IRS has prevented them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. This bill would delay the implementation of Revenue Procedure 80–5 and Revenue Ruling 80–60 to taxable years beginning after 1979 and would give taxpayers the opportunity to take mitigating action under the Treasury regulations.

3. S. 2818—Senators Talmadge, Baucus, and Pryor

Tax Treatment of Mutual or Cooperative Telephone and Electric Companies

The bill would provide that, in determining whether a mutual or cooperative telephone or electric company meets the 85-percent member-income requirement for tax exemption (under Code sec. 501(c)(12)), any income from rental of poles (used in the cooperative's exempt activities) or from display listings in a directory is to be disregarded. The bill also would provide that income from the rental of such poles by mutual or cooperative telephone and electric companies is not subject to the tax on unrelated business taxable income.

4. S. 2904—Senators Talmadge, Glenn, and Dole

Adjustments in Excise Tax on Tires

Present law imposes an excise tax of 10 cents per pound on new highway tires (to be reduced to 5 cents per pound on October 1, 1984), and 5 cents per pound on new nonhighway tires. A credit or refund is allowed with respect to tires for which a warranty or guarantee adjustment is made. However, there are no specific statutory provisions as to the proper method of computing the credit or refund.

The bill would reduce the excise taxes on new tires by 2.5 percent, beginning on January 1, 1981, and disallow an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustment is made after December 31, 1982. The bill also would provide a special rule for determining a credit or refund for tires which are adjusted after March 31, 1978, and prior to January 1, 1983. In this period, a credit or refund would be determined under the IRS administrative guidelines in effect on March 31, 1978.

B. CERTAIN SECTIONS OF HOUSE-PASSED BILL, H.R. 7171

1. Section 1.—Income Tax Exclusion for Certain Federal Scholarship Grants

Under present law, amounts received as scholarships or fellowship grants at educational institutions generally are excluded from gross income unless, as a condition to receiving such amounts, the recipient must agree to perform services for the grantor. Temporary legislation provides an exclusion for amounts received by members of a uniformed service entering the Armed Forces Health Professions Scholarship Program and similar programs before January 1, 1981.

In general, this provision of the bill exempts from taxation scholarships received under Federal programs which require future Federal service by the recipients to the extent that the scholarships are used for tuition, fees, and related expenses.

2. Sections 4 and 5.—Tax Treatment for Members of an Affiliated Group which Included a Transferor Railroad in the ConRail Reorganization

Under present law, net operating losses of a member of an affiliated group of corporations controlled by a common parent corporation may be used to offset income reported by other members of the affiliated group where a consolidated income tax return is filed by the group. In order to reflect the reduction in tax liabilities derived by the other members of the affiliated group, the basis in the loss corporation's stock owned by other members of the group is reduced by these operating losses, and, where these losses exceed basis, a negative basis (called an excess loss account) is created. The excess loss account is restored to income when, for example, the loss corporation ceases to be a member of the affiliated group or the stock of the loss corporation becomes worthless.

Section 4 of the bill specifies that, for purposes of determining when an excess loss account is restored to income under the consolidated return rules, the determination of worthlessness of stock in a corporation which was a transferor railroad in the April 1, 1976, ConRail reorganization will not occur until after a final determination of the value of the transferred rail properties by a special court formed for this purpose. This provision is intended to benefit the Norfolk and Western Railway Company.

In addition, section 5 of the bill provides that, to the extent an excess loss account arising from net operating losses of a ConRail transferor railroad from periods before or including the taxable year of the ConRail reorganization is restored as ordinary income (or its equivalent in capital gain income), the transferor's net operating losses will correspondingly be restored to the transferor railroad to apply solely against any income ultimately recognized by the transferor railroad from the ConRail reorganization. This provision is intended to benefit the Erie Lackawanna Railway Company.

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II. DESCRIPTION OF BILLS

A. SENATE BILLS

1. S. 2775—Senators Bentsen, Talmadge, Moynihan, Baucus, Dole, Chafee, and Wallop

Nonqualified Deferred Compensation Plans for Nonresident Aliens

Present law

United States businesses operating abroad often provide deferred compensation for their foreign employees. In many cases, plans are established which cover almost exclusively nonresident alien employees, rather than U.S. citizens working abroad. The foreign operations of the U.S. business may be conducted through a branch of a U.S. corporation or through a foreign subsidiary of a U.S. parent corporation.

General rules relating to deductibility of deferred compensation

In general, the year in which a taxpayer is allowed to deduct expenses, such as compensation, is determined by its method of accounting. Generally, cash basis taxpayers deduct expenses in the year they are paid, while accrual basis taxpayers deduct the expenses in the year in which all events have occurred which determine the fact of the liability and the amount of the liability can be estimated with reasonable accuracy.

However, the Code provides special rules (sec. 404) for deductions of amounts under pension and other deferred compensation plans, which must be met in addition to the usual requirements for deduction of the amounts as business expenses (secs. 162 and 212). Separate rules apply with respect to qualified and nonqualified deferred compensation plans.

Qualified plans.—In order for a deferred compensation plan to be "qualified" under the Code, contributions under it must be paid into a trust to protect them from the employer's creditors. A number of other requirements must also be met. In particular, the plan must be administered for the sole benefit of employees and their beneficiaries, eligibility to participate must be nondiscriminatory, contributions or benefits must be nondiscriminatory, and benefits must be paid no later than specified dates. Additional requirements must be met if the plan covers self-employed individuals, such as partners. The Employee Retirement Income Security Act of 1974 (ERISA) added a number of additional requirements, including, for example, new eligibility rules, minimum standards for vesting and accrual of benefits, minimum funding standards, maximum limitations on contributions and benefits, a requirement that benefits be paid in certain cases in the form of joint and survivor annuities, and prohibitions on certain dealings between the plan and related parties.

If a plan is qualified, a deduction is allowed at the time a contribution is paid into the plan's trust. The amount of the contribution allowable as a deduction is no less than the amount necessary to satisfy the minimum funding standard prescribed by ERISA. A maximum limitation is also placed on the amount of the contribution which may be deducted. Generally, this may not exceed the "normal cost" of the plan for the year plus an amount which would amortize plan benefit liabilities attributable to past service of employees (if not already included in normal cost under the funding method used by the taxpayer) over a period of no less than 10 years. (The "normal cost" is a measure intended to reflect the ratable share of the increase in plan liabilities to participants resulting from service performed that year. Under some allowable funding methods, a ratable portion of liability for past service of the employees is also included in the year's normal cost). No deduction is allowed for contributions in excess of the "full funding limitation," the amount by which the accrued liability for benefits of the plan exceeds the value of its assets. Other limitations on deductions also apply if the employer maintains qualified profit sharing or stock bonus plans for his employees. An unlimited carryforward is allowed for contributions in excess of the limitations.

Nonqualified plans.—If a plan of deferred compensation does not meet the requirements for qualification under the Code, a separate rule applies to the deductibility of contributions. The deduction is taken in the taxable year in which an amount attributable to the contribution is includible in the income of the employee. A similar rule applies to deferred compensation arrangements with independent contractors. However, if the plan covers more than one employee, the deduction may be taken only if separate accounts are maintained for each employee. Otherwise, the IRS takes the position that the contribution is never deductible, except in the case of unfunded plans where payment is made directly to the former employees.

Separate accounts are established only for defined contribution plans, which generally require that an amount established pursuant to a formula, which may vary from employee to employee, be contributed to the accounts of the participants. Each employee bears the risk of fluctuations in the value of the investments in his account. Separate accounts are not maintained, however, for defined benefit plans. These plans specify by formula the benefits which participants are to receive on retirement. Contributions to them are based on actuarial calculations of the amounts which will be required to be paid out, generally based in the aggregate on the ages and life expectancies of members of the workforce, likely turnover of participants, and expected investment performance of amounts contributed. The employer bears the risk of investment gain or loss. Because the actuarial assumptions are based on aggregate data, no separate accounts are maintained. Hence, in situations where this rule applies, no deduction is allowed for contributions to a defined nonqualified benefit plan.

Foreign deferred compensation plans

Foreign branch operations.—The Code permits the trust of a qualified plan to be organized under foreign law but does not otherwise expressly waive any of the requirements for qualification. In Letter

Ruling 7904042, the Internal Revenue Service held that if a plan for the benefit of nonresident alien employees did not meet all of the requirements for qualification under the Code (including the provisions added by ERISA), no deduction would be allowable under the rules for qualified plans described above. Instead, the Service held that amounts would be deductible, if at all, only under the rules which apply to nonqualified plans. Since the plans in question were defined benefit plans which did not maintain separate accounts for participants, the Service denied deductions for contributions made to the plans.

Foreign subsidiary operations.—Foreign subsidiaries of U.S. corporations generally do not have U.S. operations which would subject them to U.S. tax, and since their income is thus not subject to U.S. tax, the question of whether a deduction is allowed for contributions to a plan for nonresident aliens does not have the same direct effect on their U.S. tax liability as in the case of a foreign branch of a U.S. corporation. However, the treatment of the contribution in computing the foreign subsidiary's accumulated profits has important consequences in determining the indirect foreign tax credit which the U.S. parent corporation is allowed with respect to dividends received from the foreign subsidiary.[1]

Generally, if a U.S. corporation owns at least 10 percent of the voting stock of a foreign corporation from which it receives a dividend, the U.S. corporation is deemed to pay the amount of foreign income taxes paid by the foreign subsidiary on the accumulated earnings from which the dividend was paid. The U.S. corporation may then, within limitations, claim a credit against its U.S. tax liability in the amount of the foreign income taxes deemed paid by it. Under regulations, the determination of foreign taxes paid on accumulated earnings is made on a year-by-year basis, starting with the most recent year. If only part of the accumulated earnings of that year are paid out, only a proportionate part of the foreign income taxes paid with respect to the earnings for that year are deemed paid. Thus, if a dividend of a given size is paid, more of the foreign income taxes paid by the foreign subsidiaries will be deemed to have been paid by (and thus would be creditable by) the U.S. parent if the accumulated earnings of the subsidiary are smaller than if they are larger—because a proportionately larger share of the accumulated earnings would be paid out in the dividend, resulting in a greater proportion of the foreign taxes being deemed paid.

The deduction issue discussed in connection with foreign branches can also be relevant in the case of a foreign subsidiary if it conducts a U.S. business, the taxable income from which must be determined, or if it is a controlled foreign corporation (CFC).[2]

In the case of a CFC, subpart F (secs. 951–64 of the Code) provides that, in general, the United States shareholders must currently include in their income certain types of tax haven income of the corporation

[1] Section 406 of the Code permits, in limited instances, a U.S. parent corporation with a qualified plan to make contributions on behalf of employees of a foreign subsidiary who are U.S. citizens. In such cases, a deduction is allowed to the foreign subsidiary.

[2] Generally, a foreign corporation is a CFC if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom holds 10 percent or more of the voting power.

and certain types of passive investment income. Generally, the amount of this income to be taken into account is reduced by deductions properly allocable to that income, so if foreign pension costs are so allocable, it is necessary to determine whether and when they are deductible. Moreover, an indirect foreign tax credit similar to that described above may be allowed to the U.S. shareholder with respect to the amount which the shareholder must include in income. The credit is equal to the proportionate part of the foreign income taxes paid on the earnings and profits of the CFC from which the distribution is deemed to be made. Thus, questions similar to those described above arise as to the size of the earnings and profits.

In Letter Ruling 7839005, the Internal Revenue Service considered an accrual basis CFC which established an irrevocable balance sheet reserve for pension expenses. The taxpayer contended that the CFC's earnings and profits should be reduced by the amount of its pension liability which had properly been accrued. The Service held, however, that earnings and profits could be reduced only to the extent of pension payments actually made. The Service did not view as controlling the taxpayer's argument that this result would distort (generally by reducing) its allowable indirect foreign tax credit with respect to dividend distributions from the CFC.

Foreign trusts with U.S. beneficiaries.—The Code provides that if a U.S. person transfers property to a foreign trust, and a U.S. person is the beneficiary of any part of the trust, then the transferor is treated as the owner of the transferred trust property and therefore is taxable on the income earned on that part. Moreover, if the trust does not have a U.S. beneficiary at the time of the transfer but later acquires one, the transferor is subject to tax on all the undistributed net income on amounts it previously transferred to the trust. The Code expressly provides that these rules do not apply to foreign trusts established under qualified plans. However, there is no similar exception for foreign trusts under nonqualified plans. Thus, if a U.S. corporation makes a contribution to a foreign trust of a nonqualified plan, it is possible that the corporation would be taxable on the income earned on the contribution, either immediately if the trust has a U.S. person as a beneficiary, or subsequently if one of the plan participants or his beneficiary becomes a U.S. citizen or resident.

Issues

The issues are whether or not, in the case of a nonqualified plan of deferred compensation maintained for the benefit of nonresident aliens:

(1) special rules should be prescribed with respect to the allowability of deductions with respect to the plan;

(2) special rules should be prescribed as to the effect of the plan on earnings and profits; and

(3) it should be specified that the rules relating to foreign trusts with U.S. beneficiaries do not apply to contributions to such a trust under the plan.

Explanation of provisions

Allowance of deductions

The bill would provide that, in the case of a nonqualified deferred compensation plan which is maintained primarily for the benefit of

persons substantially all of whom are nonresident aliens, the general rules regarding the timing and allowability of deductions for contributions will not apply (unless the taxpayer elects to have those rules apply to the plan). Instead, if the contributions otherwise qualify for deduction as business expenses, special rules for deductibility are prescribed.

General rules.—Four general requirements apply to any deductions (except deductions for direct payments, described below) to be taken under the special rules. First, the benefits provided by the plan must be either required by foreign law or set forth in a written document communicated to the active participants. Second, in the case of a defined benefit plan, the deduction is limited to amounts paid or accrued in respect of benefits that are reasonably capable of actuarial estimation. Third, to the extent the amount taken into account is dependent upon actuarial determinations, the actuarial cost method and assumptions used must in the aggregate be reasonable. Fourth, the amount to be taken into account for the taxable year must be determined in a manner consistent with generally accepted accounting principles in the United States applicable to the charging of pension costs against income.

In addition to these general requirements, special rules are prescribed which must be met in both of the circumstances which could give rise to a liability for deferred compensation other than a direct payment: the payment of contributions to a trust or fund on the one hand, and other payment or accrual on the other hand.

Trust contributions.—If an amount is transferred to a separate trust or fund and has not been allowed previously as a deduction, then, whether or not benefits to be provided from the trust are subject to a substantial risk of forfeiture, a deduction is allowed for the amount transferred if the conditions described above under "General rules" are met and if certain other requirements are met. In the case of a defined benefit plan, the amount transferred and any income earned thereon must not revert to the employer or to the employer's benefit prior to the satisfaction of all liabilities with respect to participants and beneficiaries under the plan. Also, the transferred amount must not exceed the full funding limitation for the year. In the case of a defined contribution plan, the amount transferred and any income earned thereon must not revert to the employer or to employer's benefit, and the amount taken into account must be allocated to individual accounts of participants that will be adjusted at least annually for the income and expenses of the fund. As is currently the case with qualified plans, a taxpayer will be allowed a deduction with respect to a taxable year if the contribution on which the deduction is based is made by the time the taxpayer files a timely return for that year.

Other payments and accruals.—If the above requirements relating to payment into a trust or fund are not met, but the conditions described above under "General rules" are satisfied, then a deduction is allowed at the time of payment or accrual, if the amount is paid or accrued in respect of benefits that are not subject to a substantial risk of forfeiture, and, if the amount is accrued, it represents the actuarial present value of such accrued benefits.

Direct payments.—The bill also provides that, if a deduction has not previously been allowed under the above rules, it will be allowed when a payment, which is not subject to a substantial risk of forfeiture, is made to a participant or beneficiary by an employer.

Nonresident alien participation.—As described earlier, these rules apply only where substantially all of the beneficiaries are nonresident aliens. The bill provides for a reduction of the deduction otherwise allowable where not all the active participants are nonresident aliens. Generally, the amount otherwise allowable is to be multiplied by a fraction, the numerator of which is the payments or accruals made on behalf of active participants who are nonresident aliens, and the denominator of which is the payments or accruals made on behalf of all active participants. However, no reduction is required if during the taxable year at least 95 percent of all active participants are nonresident aliens, and at least 95 percent of the contributions made to or benefits accruing under the plan are in respect of active participants who are nonresident aliens.

Other rules.—The bill allows an unlimited carryforward of amounts not currently deductible (except amounts disallowed because of the participation of individuals other than nonresident aliens). The bill also requires that whatever accounting method is used to determine the deductible amount must be used consistently. Changes in the accounting method (but not actuarial assumptions) would require the permission of the Service.

Effect on earnings and profits

The bill would provide that, if an amount would be deductible under the special rules provided by the bill, the earnings and profits of the corporation are to be reduced to the same extent.

Foreign trusts

The bill would make it clear that in the case of a contribution to a foreign trust subject to the special deduction rules, the corporation making the contributions is not treated as the owner of part of the trust merely because the trust has or acquires U.S. beneficiaries.

Effective date

The bill would be effective upon enactment.

Revenue effect

The revenue estimate for this bill is not yet available.

2. S. 2805—Senator Nelson

Deferred Application of Revenue Procedure 80-5 and Revenue Ruling 80-60 Relating to Inventory Writedowns

Present law

Background

On February 8, 1980, the Internal Revenue Service issued a news release (Internal Revenue-News Release IR-80-19, I.R.B. 1980-6) announcing the publication of Revenue Procedure 80-5 and Revenue Ruling 80-60. Both pronouncements dealt with the Supreme Court decision in *Thor Power Tool Company* v. *Commissioner*, 439 U.S. 522 (1979), and the writedown of excess inventories. The *Thor Power* decision held that a writedown of any item of inventory would be allowed for tax purposes only if it as in accordance with certain procedures set forth in the Treasury regulations. Any other writedowns would not be considered proper and would not be allowed for tax purposes. The IRS pronouncements required full implementation of the *Thor Power* decision for taxpayers with 1979 calendar year-ends.

Thor Power Tool Company manufactured hand held power tools that contained from 50 to 200 parts. The company had a policy of manufacturing all future estimated replacement parts at the same time it manufactured a new product. In this way the company sought to avoid the problem of having to retool at some future date in order to provide replacement parts to its customers. Therefore, the company had more replacement parts on hand than it would need in the immediate future ("excess inventory").

In 1964, Thor Power's new management determined that a large portion of the parts inventory was in excess of any reasonably foreseeable future demand. Therefore, they wrote the inventory down to scrap value for both financial statement purposes and tax purposes. However, the taxpayer did not make any attempt to sell these goods at a reduced price nor to scrap them but instead retained the parts for possible future sale to customers at their original list price.

Under section 471 of the Internal Revenue Code, the taxpayer is required to keep inventories in a manner that conforms as nearly as possible to the best accounting practice in its trade or business and that most clearly reflects its income. Upon audit, the Commissioner conceded that Thor Power's method of accounting for its inventory was in conformity with the best accounting practice in its trade or business because it was standard accounting policy to writedown excess inventories to their net realizable value. However, the Commissioner determined that the writedown did not clearly reflect the taxpayer's income. The Commissioner contended that in order to clearly reflect income for tax purposes the writedown had to conform to the requirements of section 471 regarding market writedowns and that the taxpayer's writedown did not conform to those requirements.

The regulations under section 471 allow a taxpayer to writedown its inventory to the lower value of cost or market. In general, the definition of the market price of a product is the bid price in the market place for such a product. In Thor Power's situation, the replacement parts had not diminished in value with respect to their market price but the taxpayer felt that there were so many of these parts that they would not all be sold. Therefore, its writedown did not reflect a lower market value of the individual parts but reflected the fact that Thor Power would not be able to sell all the parts. Such a writedown does not qualify under the regulations as a tax deductible writedown.

In addition to the market price writedown, the regulations provide for two other circumstances where inventory can be written down below its cost. The first is where the taxpayer actually *offers* the property for sale at prices below the current market price of the inventory during the tax year of the writedown. In that case, the taxpayer may value the inventory at the price being offered less the direct costs of disposition. The second situation is in the case of goods that are not saleable at normal prices because of damage, imperfections, shop ware, and other similar infirmities ("subnormal goods"). In the case of such unsaleable goods, the taxpayer may value the inventory at a bona fide selling price less direct costs of disposition. The bona fide selling price is defined as the selling price at which the goods are actually offered for sale during a period ending not later than 30 days after the inventory date (generally the corporation's year-end). In both of these situations, the taxpayer must actually offer the goods for sale.

In *Thor Power*, the taxpayer wrote the inventory down below the market value but did not offer the parts for sale at a reduced price. In fact, the company conceded that it continued to sell these parts at their original list prices. The Supreme Court held that in order for a taxpayer's method of inventory accounting to clearly reflect income, and thus to be an allowable method of inventory accounting under section 471, it must conform to the writedown requirements in the Treasury regulations. Since Thor Power's inventory writedown did not conform to these regulations, it was held to be an improper method of inventory accounting and the deduction for the writedown was denied.

Rules relating to changes in methods of accounting

Under Code section 446, a taxpayer may not change the method in which he accounts for his income unless he secures the consent of the Commissioner. This is to prevent taxpayers who account for their income in one manner from changing to another manner and avoiding tax as a result of the change. For instance, if in year one a cash basis taxpayer sells property for $100 on account, income is not recognized until the $100 is actually received in a subsequent year. If in year two, however, the taxpayer changes to an accrual method of accounting, no income will be recognized for that year because under the accrual method of accounting the year for reognizing the $100 of income is the year in which the account receivable arose, which was year one. In the absence of special rules, this would be the result even though the account receivable is paid in year two because the payment of an account receivable does not give rise to income under the accrual method of accounting. Thus, in this example the taxpayer would avoid entirely the recognition of the $100 of income on the sale.

In order to prevent taxpayers from avoiding tax as a result of changing accounting methods, Code section 446 provides that the taxpayer may not change his method of accounting, even if it is an erroneous method of accounting, without obtaining the permission of the Commissioner. This allows the Commissioner the opportunity to permit the change but only if the taxpayer will make adjustments that will result in the clear reflection of his income. (The amount of the adjustment is actually computed under section 481 and is referred to as the "section 481 adjustment.") However, this procurement has the rather anomalous result of requiring a taxpayer to continue an erroneous method of accounting unless he has secured the consent of the Commissioner to change.

With respect to the *Thor Power* decision, the Internal Revenue Service believed that many taxpayers would not request permission to change the proper method of accounting for excess inventories and, under the requirement that they maintain their method of accounting, they would continue to improperly writedown excess inventories. This not only gave taxpayers the advantage of continuing to write off excess inventories until eventually challenged by the Internal Revenue Service on audit, but it held out the prospect that their erroneous method of inventory accounting might never be discovered by the IRS.

As a response to the possibility that taxpayers would not request permission to change erroneous methods of inventory accounting in accordance with the *Thor Power* decision, the Internal Revenue Service issued Revenue Procedure 80-5 and Revenue Ruling 80-60 on February 8, 1980. Revenue Procedure 80-5 granted blanket permission to all taxpayers that they may change their method of accounting in conformity with the *Thor Power* decision. Revenue Ruling 80-60 presented a fact situation regarding excess inventories and in its conclusion stated that if a taxpayer did not account for its inventory in accordance with the *Thor Power* decision and Revenue Procedure 80-5 that the taxpayer would be filing his tax return "not in accordance with the law." The obvious implication of this last statement is that the taxpayer would be liable for various penalties for failure to file a proper tax return.

Principal taxpayer argument

It is the position of taxpayers that the retroactive application of the two IRS pronouncements (i.e., the pronouncements were issued in 1980 but were to actually take effect in 1979) precludes them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. The taxpayers claim that if they had proper notice of the pronouncements in 1979 they would have offered a large part of their excess inventory for sale at reduced prices in 1979. Thus, they would have been in compliance with both the Treasury regulations and the *Thor Power* decision on those inventory writedowns and would not have had to recapture income with respect to that inventory. However, since the goods have to be offered for sale in the taxable year in which the writedown is to be taken, taxpayers claim that issuance of the pronouncements in 1980 prevented them from taking any action in 1979.

Issue

The issue is whether the application of Revenue Ruling 80-5 and Revenue Ruling 80-60 should be delayed from 1979 to 1980.

Explanation of the bill

The bill would delay the effective date of Revenue Procedure 80-5 and Revenue Ruling 80-60 from tax years ending on or after December 25, 1979 to tax years beginning after December 31, 1979.

Effective date

The bill would apply to tax years ending after December 31, 1979.

Revenue effect

It is estimated that this bill will reduce budget receipts by about $25 million in fiscal year 1980 and increase them by the same amount in later years, primarily fiscal year 1990.

3. S. 2818—Senators Talmadge, Baucus, and Pryor

Tax Treatment of Mutual or Cooperative Telephone and Electric Companies

Present law

Rural cooperatives

Under present law (Code sec. 501(c)(12)), a mutual or cooperative telephone company qualifies for exemption from Federal income taxation only if at least 85 percent of its income consists of "amounts collected from members for the sole purpose of meeting losses and expenses." In determining whether this member-income test has been satisfied, amounts of credits accrued or received by a mutual or cooperative telephone company from another company for communications services on calls involving members of the telephone cooperative are not taken into account.

Similarly, a rural electric cooperative may qualify for exemption from Federal income taxation under Code section 501(c)(12) if it satisfies the 85-percent member-income test.[1]

Tax on unrelated business income

Under present law, most organizations which are generally tax exempt under the Internal Revenue Code are nonetheless subject to tax on unrelated business taxable income (Code sec. 511). Thus, unless a specific exception applies, an organization which is tax-exempt (under Code sec. 501(a))[2] is subject to tax with respect to income derived from any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds) to the exercise or performance of its exempt function.

Recently, the Internal Revenue Service has indicated that income from the rental of poles (*e.g.*, payments by rural electric cooperatives for use of a rural telephone cooperative's poles) and display listings in "Yellow Page" directories may be included in nonmember income of rural cooperatives.

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[1] See Rev. Rul. 65-99, 1965-1 C.B. 242; Rev. Rul. 65-174, 1965-2, C.B. 169. In addition, certain rural electric cooperatives in the Tennessee Valley Authority ("TVA") area are exempt from taxation under Code section 501(c)(4) even though, generally because of TVA requirements, they do not meet the 85-percent member-income test. See *U.S.* v. *Pickwick Electric Membership Corp.*, 158 F.2d 272 (6th Cir. 1946).

[2] In this pamphlet, references to "tax-exempt organizations" do not include social clubs (Code sec. 501(c)(7) and employees' beneficiary associations (Code sec. 501(c)(9), which are taxable on investment income of all types as well as unrelated business income. The term "tax-exempt organizations," as used in this pamphlet also does not include political organizations (described in Code sec. 527) and homeowners' associations (described in Code sec. 528).

Issues

The issues are whether income from pole rentals and display listings should be treated as nonmember income for purposes of the 85-percent member-income test and whether income from pole rentals should be subject to the tax on unrelated business taxable income.

Explanation of the bill

The bill would provide that, in applying the 85-percent member-income test to a mutual or cooperative telephone company, any income from qualified pole rentals or from display listings in a telephone directory is to be disregarded. Also, in applying the 85-percent non-member-income test to mutual or cooperative electric companies, any income from qualified pole rentals is to be disregarded. Income from qualified pole rentals generally means any income from the sale of the right to use any pole (or other structure) (1) which is used by the cooperative in providing telephone or electric services to its members, and (2) the use for which the pole is rented involves the transmission by wire of electricity or of telephone or other communications.

The bill also would provide that the engaging in activities which result in the receipt of qualified pole rentals is not an unrelated trade or business for a mutual or cooperative telehpone or electric company. Thus, such rentals would not be subject to the tax on unrelated business taxable income.

Effective date

The amendments relating to the 85-percent member-income test would apply to all taxable years to which the Internal Revenue Code of 1954 applies.

The amendments to be unrelated business income provisions would apply to all taxable years beginning after December 31, 1969 (the general effective date of the provisions of the Tax Reform Act of 1969 which applied the tax on unrelated business taxable income to organizations exempt under Code sec. 501(c)(12)).

Revenue effect

It is estimated that this bill will reduce budget receipts by less than $5 million annually.

4. S. 2904—Senators Talmadge, Glenn, and Dole

Adjustment in Excise Tax on Tires

Present law

Present law (sec. 4071(a) of the Code) imposes a manufacturers excise tax of 10 cents per pound on new tires[1] of the type used on highway vehicles, and 5 cents per pound on new nonhighway tires. The tax on new highway tires is scheduled to be reduced to 5 cents per pound on October 1, 1984 (sec. 4071(d)); the tax on nonhighway tires is to remain at 5 cents per pound. Revenues from the tax on tires go into the Highway Trust Fund (through September 30, 1984).

Since these taxes are imposed on the basis of the weight of the tire, the price for which the tire is sold generally does not affect the amount of tax due on a manufacturer's sale. However, under IRS administrative guidelines (Rev. Rul. 59–394, 1959–2 CB 280), an exception occurs when a tire manufacturer sells a new replacement tire at a reduced price pursuant to a warranty or guarantee on the tire that is being replaced. Then the manufacturers excise tax on the replaced tire is to be reduced in proportion to the reduction in price of the replacement tire. This amount is allowable as a credit or refund (without interest) of the manufacturers excise tax on the replaced tire (sec. 6416(b)).

The tire industry's practice has been to apply this rule based on the proportionate reduction in the price to the ultimate consumer where the warranty or guarantee is invoked by the ultimate consumer. This reduction is often greater than the reduction in the price of the replacement tire to the vendee who provides the replacement tire to the ultimate consumer. However, the Internal Revenue Service has taken the position (Rev. Rul. 76–423, 1976–2 CB 345) that the tax should be reduced in proportion to the reduction in price from the manufacturer to its immediate vendee—usually, a wholesaler or a dealer. Under current warranty or guarantee practices used in the tire industry, the Service's position generally produces a smaller tax reduction (hence, a larger net tax) than that produced by a rule that is based on the adjustment in the sale price to the ultimate consumer.

Revenue Ruling 76–423 also provides similar rules for the situation where the manufacturer's warranty or guarantee runs to the dealer but not to the ultimate consumer, and where the replacement tire is not from the same manufacturer as the original tire being returned under the warranty or guarantee. Finally, the ruling provides that,

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[1] The tax applies on the sale (sec. 4071(a)(1) and (2)) or delivery to a retail outlet (sec. 4071(b)) of a manufacturer, producer or importer. (A lease (sec 4217) or use (sec. 4218) is treated as a sale for these purposes.) In general, this means that, as to domestically manufactured tires, the tax applies to new tires and also to tires that have been retreaded "from bead to bead" (thereby making them new articles). As to imported tires, the tax applies whether or not the tire is new, if the tire has not previously been taxed in the United States. Tires on imported articles (other than articles taxed under sec. 4061 as trucks, etc.) also are subject to tax.

where the manufacturer initially sells tires to a dealer "under a price reduction arrangement in lieu of a warranty," no adjustment in excise tax is allowable.

As originally announced, the 1976 ruling was to have taken effect with respect to this issue on April 1, 1977. After having been twice postponed by the Service, the effective date of the 1976 ruling became April 1, 1978.

Issues

The principal issue is whether the current system of excise taxes on tires should be replaced with a system under which lower tax rates would apply to new tires and no credit or refund would be allowed with respect to tires for which a warranty or guarantee adjustment is made. Such a system could be designed in a manner that would have no significant effect on the overall receipts from the excise taxes on tires.

Another issue is whether, for periods for which credits or refunds are allowed, excise tax credits or refunds should be determined under the tire industry's prior practices or under the rules prescribed in Rev. Rul. 76-423.

Explanation of the bill

The bill would reduce the rate of manufacturers excise tax on new tires by 2.5 percent, beginning on January 1, 1981. Thus, the tax on new highway tires would be reduced to 9.75 cents per pound on January 1, 1981, and to 4.875 cents per pound on October 1, 1984; and the tax on new nonhighway tires would be reduced to 4.875 cents per pound on January 1, 1981.

The bill also would provide a special rule for the determination of an excise tax credit or refund with respect to tires for which a warranty or guarantee adjustment is made. For the adjustment of any tire after March 31, 1978, and prior to January 1, 1983, a credit or refund would be determined under the practice used by the industry prior to the effective date of Rev. Rul. 76-423. No credit or refund would be allowed for a warranty or guarantee adjustment of any tire after December 31, 1982.

Effective date

The amendments relating to excise tax rates would apply for new tires sold after December 31, 1980.

The provisions relating to the determination of an excise tax credit or refund would apply to the adjustment of any tire after March 31, 1978, and prior to January 1, 1983.

The amendments relating to disallowance of an excise tax credit or refund would apply to the adjustment of any tire after December 31, 1982.

Revenue effect

Because it would reduce excise tax rates on new tires for two years before it would first disallow credits or refunds, it is estimated that the bill would decrease net excise tax receipts (receipts less credits and refunds) by $15 million in fiscal year 1981, by $20 million in fiscal year 1982, and by $5 million in fiscal year 1983. The bill would have negligible effects on net receipts after fiscal year 1983.

B. CERTAIN SECTIONS OF HOUSE-PASSED BILL, H.R. 7171

1. Income Tax Exclusion for Certain Federal Scholarship Grants (Sec. 1 of the bill)

Present law

Code section 117 provides that amounts received as scholarships at educational institutions and amounts received as fellowship grants generally are excluded from gross income. This exclusion also applies to incidental amounts received to cover expenses for travel, research, clerical help, and equipment. However, the exclusion for scholarships and fellowship grants is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient. Educational grants are not excludable from gross income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Treas. Reg. § 1.117-4(c)).

Certain Federal scholarship programs require, as a condition of their award, performance of future service for the Federal Government. The Internal Revenue Service has ruled that awards under these programs would not be excludable from gross income under the general scholarship provision (Rev. Rul. 76-99, 1976-1 C.B. 40). However, special temporary legislation provides that recipients of Armed Forces Health Professions scholarships, Public Health Service scholarships, and similar programs may exclude from gross income amounts received as scholarships under these programs. This temporary exclusion will not apply to scholarships awarded students entering these programs after December 31, 1980. (This temporary exclusion was most recently extended by P.L. 96-167.)

Issue

The issue is whether, on a permanent basis, Federal scholarships conditioned on the recipients' future services as Federal employees should be includible or totally or partially excludable from gross income.

Explanation of provision

This section of H.R. 7171 would provide that an amount, which is received by an individual as a grant under a Federal program [1] and which would be excludable from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future

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[1] The House Committee on Ways and Means understood that this provision will not affect the treatment of payments to cadets and midshipmen at the United States military academies. An appointee to a military academy is considered a member of the regular military service. See Rev. Rul. 55-347, 1955-1 C.B. 21. Thus, the taxability of payments made to cadets and midshipmen is governed by provisions other than the scholarship provision.

service as a Federal employee, would not be includible in gross income if the individual establishes that the amount was used for qualified tuition and related expenses.

The excludable qualified tuition and related expenses are amounts used for tuition and fees required for the enrollment or attendance of the student at an institution of higher education and for fees, books, supplies, and equipment required for courses of instruction at that institution.

The provision defines an "institution of higher education" as a public or other nonprofit educational institution in any State which: (1) admits as regular students only individuals who have a certificate of graduation from a high school (or the recognized equivalent of such a certificate); (2) is legally authorized within the State to provide a program of education beyond high school; and (3) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized health profession.

The tax treatment of scholarships and fellowships, other than those specifically covered by the bill, would remain governed by the present law rules under Code section 117.

Effective date

The provision would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this provision would reduce budget receipts by $3 million in fiscal year 1981, $8 million in fiscal year 1982, $14 million in fiscal year 1983, $20 million in fiscal year 1984, and $24 million in fiscal year 1985.

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2. Tax Treatment for Members of an Affiliated Group Which Included a Transferor Railroad in the ConRail Reorganization (Secs. 4 and 5 of the bill)

Present law

On April 1, 1976, a number of insolvent midwestern and eastern railroads, along with many of their subsidiaries and affiliates, transferred their railroad properties to the Consolidated Rail Corporation (ConRail). These transfers were mandated and approved by the Congress [1] in order to provide financially self-sustaining rail services in areas served by these bankrupt railroads.

Under the legislation which established it, ConRail, a taxable corporation, was to acquire, rehabilitate, and operate the railroad properties. The transferor railroads (and their subsidiaries and affiliates) received ConRail stock and certificates of value issued by the United States Railway Association, a nonprofit Government corporation formed to oversee the ConRail reorganization. Valuation of the transferred railroad properties, and the corresponding value of the certificates of value received by the transferor railroads, is to be determined ultimately by a special court created for this purpose.

In 1976, the Congress also enacted legislation to deal with certain of the tax consequences of this reorganization to ConRail, the transferor railroads, and the shareholders and creditors of the transferor railroads. Under this legislation,[2] the transfer of rail properties to ConRail was treated like reorganizations in general (and other bankrupt railroad reorganizations in particular) so that the transferor companies and their shareholders and security holders did not recognize gain or loss on the transfer and ConRail received a carryover basis in the properties it acquired (Code sec. 374(c)). In addition, where the carryover period has expired for a transferor railroad's net operating losses which were incurred before and during the taxable year in which the ConRail reorganization took place, these losses generally may be revived to apply against any income eventually recognized from the ConRail transfer (Code sec. 374(e)).

The 1976 tax legislation did not deal with certain other aspects of the ConRail reorganization, such as investment credit recapture to the transferor railroads which arose from the mandated transfer of assets to ConRail. To deal with this aspect of the ConRail reorganization, the Revenue Act of 1978 (P.L. 95-600, approved November 6, 1978) added an exception to the investment credit recapture rules so that a

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[1] The facilitating legislation for the transfers was the Regional Rail Reorganization Act of 1973 (P.L. 93-236, approved January 2, 1974) and the Railroad Revitalization and Regulatory Reform Act of 1976 (P.L. 94-210, approved February 5, 1976).

[2] P.L. 94-253, approved March 31, 1976.

transferor railroad will not be subject to recapture of the investment credit because of its transfer of railroad properties to ConRail.

Present law also provides rules which deal with the filing of consolidated returns by affiliated groups of corporations.[3] Under the section 1502 consolidated return regulations, income tax liability generally is based on the combined income of the corporations in the affiliated group. Where one or more members of the affiliated group have incurred net operating losses, these losses offset taxable income of other members of the affiliated group, and the tax basis of their investment in the stock of the loss corporation is reduced, generally by an allocated portion (based on stock ownership) of the losses reflected in the consolidated return. If the losses used on the consolidated returns exceed the basis of the stock owned by the other members of the group, the result is the creation of excess loss accounts which are the equivalent of negative basis in the stock of the loss corporation owned by the other members.

Where there is a disposition of the loss affiliate's stock or the stock ownership requirements for an affiliated group cease to be met, any excess loss accounts in existence at that time are "restored" by treating them as income.[4] The term disposition is broadly defined and includes the occurrence of worthlessness of the loss affiliate's stock. In these situations, ordinary income will result to the extent of "insolvency" of the loss affiliated and special rules are provided for determining insolvency in situations concerning excess loss accounts. Where an excess loss account is restored, a previously used net operating loss in not restored to the loss affiliate.

Issues

The first issue is whether a rule should be provided concerning the application of the consolidated return regulations to an affiliated group which included a transferor railroad in the ConRail reorganization.

The second issue is whether net operating losses of a transferror railroad should be restored to be used to offset income eventually recognized as a result of the ConRail transfer if the affiliated group, of which the transferor railroad had been a member, restores to income the excess loss account arising from the use of the net operating losses on a consolidated return for the affiliated group.

Explanation of provisions

Consolidated return regulations (sec. 4 of the bill)

Section 4 of the bill would provide a statutory rule, for purposes of applying the consolidated return regulations, under which the determination of worthlessness of the capital stock of a transferor railroad in the ConRail reorganization is postponed until a deter-

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[3] These rules are primarily set forth in regulations promulgated under specific statutory authority (Code sec. 1502). An affiliated group of corporations is generally defined as a group of corporations connected with a common parent corporation through ownership of at least 80 percent of the voting power of all classes of voting stock and at least 80 percent of each class of nonvoting stock.

[4] These rules are necessary in order to reflect the reduction in tax liability which the other members of the affiliated group have derived through use of the losses.

mination of value by the special court becomes final. Under this rule, where the question of whether there have been certain types of dispositions (called "deemed dispositions") of a ConRail transferor railroad's stock under the consolidated return regulations depends upon the determination of value by the special court, a deemed disposition will not be considered as occurring until the earlier of either the date the special court's determination becomes final or the occurrence of another event which causes restoration of the excess loss account under the consolidated return regulations. The specific types of deemed dispositions which are addressed by this provision are: (1) worthlessness of the stock of the transferor railroad and, (2) where 10 percent or less of the face amount of an obligation of the transferor railroad will be recoverable at maturity by its creditors, as these two types of deemed dispositions are described in Income Tax Regulations § 1.1502–19(b)(2) (iii) and (iv), respectively. As a result, the excess loss account will be restored before the special court's determination becomes final if, for example, the transferor railroad ceases to be a member of the affiliated group, or if another member of the affiliated group transfers an obligation of the transferor railroad to a nonmember of the group for 25 percent or less of its face value.

Section 4 of the bill is intended to benefit the Norfolk and Western Railway Company.

Net operating losses (sec. 5 of the bill)

Under section 5 of the bill, it is provided that if an excess loss account arising from the net operating losses of a transferor railroad is restored to income of the affiliated group which filed consolidated income tax returns with the transferor railroad, these losses which are subject to the revival provisions generally under the ConRail reorganization will be restored to the transferor railroad in an amount which corresponds to the ordinary income (or its equivalent in capital gain income adjusted to reflect the lower capital gains rate) recognized by the affiliated group through triggering the excess loss account. Because existing law concerning the revival of net operating losses by ConRail transferor railroads applies only to those losses incurred before or during the taxable year which includes the April 1, 1976, ConRail transfer, the net operating losses which are eligible for restoration to the transferor railroad under this provision are limited to those of the transferor railroad which contributed to the excess loss account and which are incurred either in the first taxable year which ends after March 31, 1976, or in a prior taxable year, and which could be carried over to the first taxable year which ends after March 31, 1976.

A first-in-first-out rule is also provided for purposes of this provision so that the restoration of the excess loss account will be considered, for purposes of restoring net operating losses to the transferor railroad under this provision, to result from the earliest of the losses which created the excess loss account. The net operating losses which are restored may only be applied against income which is eventually recognized from the March 31, 1976, transfer to ConRail. In addition, where losses eligible for restoration to the transferor

railroad are attributable to capital gain income recognized by other members of the affiliated group (through restoration of the excess loss accounts) these losses will be restored to the transferor railroad only in amounts equal to the ordinary income equivalent of these capital gains. The ordinary income equivalent of the capital gain is the capital gain multiplied by a fraction, the numerator of which is the capital gain tax rate of corporations for the taxable year in which the excess loss accounts were restored, and the denominator of which is the maximum rate of tax on ordinary income of corporations for this taxable year.

The provisions of section 5 of the bill can be illustrated by the following example. Assume that the basis of a transferor railroad's stock owned by the other members of the affiliated group had been reduced to zero at the end of 1974, because of prior losses used by the group, that the transferor railroad incurred net operating losses of $10 million in calendar year 1975, $20 million in 1976, and $15 million in 1977, and that in 1978 it had $10 million of income. Assume further that in 1979 the transferor railroad ceased to be a member of the affiliated group, and the excess loss accounts of the other members of the group, $35 million in total, are restored as ordinary income to the group. Because of the ordering rule in the bill, the $10 million of the transferor railroad's income in 1978 is deemed to offset its post-1976 loss. Accordingly, the full $30 million of losses which were incurred in 1975 and 1976 (and which increased the excess loss account) will be restored under the rules of the bill. In addition, if the transferor railroad is insolvent to the extent of $20 million at the time of the restoration of the excess loss accounts, the amount of the restoration of losses to the transferor would be $20 million plus 28/46 times $10 million, or a total of $26,086,956. This reflects the second aspect of the ordering rule, which attributes the ordinary income portion of the restoration to the earliest losses of the transferor railroad.

Section 5 of the bill is intended to benefit the Erie Lackawanna Railway Company, a member of the affiliated group of corporations of which the Norfolk and Western Railway Corporation is the present corporation.

Effective date

The provisions apply to deemed dispositions of a ConRail transferor's stock for taxable years ending after March 31, 1976, and to restorations after March 31, 1976, of excess loss accounts attributable to net operating losses of a ConRail transferor.

Revenue effect

The revenue effects of sections 4 and 5 of the bill are indeterminate with respect to both the amount of tax involved and the timing of tax payment.

If the excess loss account were restored to income for the 1976 tax year, the Norfolk and Western Railway Company would incur an additional tax liability of about $15 million. However, the amount of estimated tax liability, if any, may be adjusted after the determination of value by the special court. Because the taxpayer is

expected to oppose assertion of a deficiency for its 1976 tax year, there would be an effect on budget receipts only if the taxpayer's position were not sustained and this occurred before the determination of the value by the special court became final or the Erie Lackawanna Railway Company ceased to be a member of the affiliated group of corporations of which the taxpayer is the parent corporation.

Restoration of the net operating losses to the Erie Lackawanna Railway Company could eventually decrease budget receipts by some amount of less than $15 million. However, these potential revenue losses are not expected to take place before fiscal year 1986.

Senator BYRD. The hour of 9 o'clock having arrived, the committee will come to order.

With Congress looking closely at possible tax reductions for individuals and businesses, the effect of estate taxes should be given careful attention. Just as high taxes have a dampening effect upon capital formation and investment, estate taxes can also have a similar effect.

Farms and small businesses face severe liquidity problems upon the death of their principal owner. Estate taxes can cause the liquidation of many going enterprises to pay the taxes. Often small businesses are forced to merge with larger businesses at the expense of the ingenuity and entrepreneurial spirit of small business to plan for the payment of estate taxes.

Just as individuals have experienced a rapid increase due to inflation, so has inflation adversely affected estates. Assets have been driven up in value through inflation, and many estates which would in the past have not had any estate tax will suddenly be confronted with a large estate tax bill.

The subcommittee today will consider S. 2967, a proposal introduced by Senator Nelson of Wisconsin, myself, and Senator Wallop of Wyoming, which is designed to assist farms and small businesses in meeting liquidity problems, and to simplify and clarify provisions in the estate tax law.

The bill is the result of recommendations and suggestions which the subcommittee received in connection with testimony on estate tax bills proposed by Senators Nelson, Dole, and Wallop, and represents a corroborative effort to develop a reasonable approach to revising the estate tax law.

In addition to S. 2967, the subcommittee will consider several miscellaneous Senate tax bills. S. 2775, S. 2805, S. 2818, and S. 2904, and one House bill, H.R. 7171 which has passed the House of Representatives.

Before calling on the first witness, I would like to see if Senator Packwood has a statement that he would like to make.

Mr. PACKWOOD. I have no statement, Mr. Chairman.

Senator BYRD. Thank you, Senator Packwood.

[The prepared statements of Senators Nelson and Dole follow:]

Statement of Senator Gaylord Nelson

Mr. Chairman, today the Subcommittee on Taxation and Debt Management continues hearings it began several months ago on estate and gift tax reform. As a result of those previous hearings and extensive consultation with estate tax experts from around the country, you and Senator Wallop joined me in introducting the Family Enterprise Estate and Gift Tax Equity Act, S. 2967.

The major features of this measure are:

An increase from $175,000 to $500,000 in the amount of property that may pass free of Federal estate and gift taxes;

A provision which exempts from estate and gift taxes all property inherited by or transferred to a spouse;

A provision which doubles the amount of property which an individual may give tax-free annually to another individual from $3,000 to $6,000 and;

A simplification of the so-called special use valuation rule for farms and closely held businesses to take into consideration the problems of those who are disabled, receiving old-age benefits, elderly spouses, minors, and students.

The measure would provide estate tax relief to more than 95 percent of our Nation's family-owned farms and businesses, allowing them to continue their many contributions to the American economy—creating more jobs, advancing technology and innovation, and increasing our productivity.

The proposal also recognizes once and for all the importance of a working spouse in a family enterprise. By providing for an unlimited marital deduction, the proposal establishes a long deserved measure of quality between spouses.

It includes some of the most extensive reforms of the Federal estate and gift tax law for farms and family businesses over the past 40 years.

I look forward to reviewing the testimony of today's distinguished panel of witnesses.

Statement of Senator Dole

Mr. Chairman, today we have an opportunity to hear the views of members of the public on several bills which could be of substantial interest to many of our taxpayers.

Revision of the estate and gift tax laws has continued to attract the interest of many individuals since our efforts culminating in the Tax Reform Act of 1976. It is evident that the 1976 act was not a perfect piece of legislation. For example, the carryover basis provision we finally repealed this year and the inadequate rules relating to special use valuation for farm property immediately come to mind. In addition, the outrageous inflation which has afflicted this country in recent years leads to an inescapable conclusion that further review of the estate and give tax laws is timely and appropriate.

I am especially pleased to note that S. 2965 contains a provision similar to S. 1859 which was introduced earlier by myself and Senator Percy to make clear that crop share rentals could be considered in the determination of a family farm's value for estate tax purposes. This provision has been made necessary by the unreasonable position of the Treasury Department, and I am pleased that this problem is being brought to the attention of this Committee once again.

Among the other proposals to be discussed is the subject of tax treatment of amounts contributed to foreign pension plans. There is concern over whether special rules should be adopted to recognize the different considerations involved—foreign plans established in compliance with foreign law and our own domestic plans. Testimony on the subject may be very instructive.

Also, the subject of tax treatment of Federal scholarships which include a requirement of subsequent Federal service is of great primary importance. If we do not establish a permanent rule in this area, we may risk loss of health professionals in Federal programs who are now committed to service through the Armed Forces Health Profession's Scholarship Program and the Public Health/National Health Service Corps Scholarship Program. This would be a great disservice to our country.

S. 2938 which I and several of my colleagues introduced recently also includes a temporary extension of the exemption for National Service Awards. Unlike the scholarships programs discussed earlier, this program presents special problems which I hope we can solve during a 1 year extension.

Another one of the bills considered today is S. 2904 which would make some helpful modifications in the excise tax system relating to tires. The bill would, after a two year transitional period, eliminate the administratively burdensome system of providing manufacturers with a credit or refund of excise taxes paid when a time warranty adjustment is made. To offset the loss form the elimination of this warranty adjustment system, the manufacturer's excise tax on new times would be reduced

by 2.5 percent. This proposal seems to offer a real simplification of an overly complex area of the tax law, with only a nominal revenue loss.

In conclusion, Mr. Chairman, this hearing should provide us with useful comment on several proposals which seem to merit serious consideration.

Senator BYRD. The first witness will be the Honorable Daniel I. Halperin, Deputy Assistant Secretary for Tax Legislation, Department of the Treasury.

Welcome, Mr. Secretary. You may proceed as you think best.

STATEMENT OF HON. DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY FOR TAX LEGISLATION, DEPARTMENT OF THE TREASURY

Mr. HALPERIN. We have a detailed statement, which I would like to submit for the record.

Senator BYRD. We have it, and it will be included in the record.

Mr. HALPERIN. I would like to comment briefly on the matters before you.

As you indicated, the hearing is concentrating on estate and gift tax matters. There is also a half-dozen other miscellaneous bills that are the subject of the hearing before you, and I would like to comment on those first.

Aside from S. 2805, the Treasury does not have significant opposition to these miscellaneous bills.

Senator BYRD. I did not understand what you said.

Mr. HALPERIN. Of the miscellaneous matters before you, S. 2805 is the only one which we have opposition to.

Senator BYRD. You have no opposition to the others, only to S. 2805.

Mr. HALPERIN. That is correct, that is aside from the estate and gift tax matters, Mr. Chairman.

Senator PACKWOOD. Now say that again. You have substantial objections to S. 2967.

Mr. HALPERIN. That is correct.

Senator PACKWOOD. All right.

Senator BYRD. But you support S. 2775, S. 2818, S. 2904, and H. R. 7171; is that correct?

Mr. HALPERIN. We support S. 2775, S. 2818, and S. 2904. We don't object to the changes in H.R. 7171 that deal with the Conrail provisions. We have not indicated any position in our written statement on section 1 of H.R. 7171. There is a dispute within the administration on that provision. The Treasury Department and the Department of Defense do support that part of the bill.

Senator BYRD. Very good. Why don't you take up S. 2805, and then get to S. 2967.

Senator PACKWOOD. I think that it might be worth, Mr. Chairman, when other witnesses come, because I know some of them may be late, calling to their attention to the fact that in the case of those bills, Treasury supports them. They may not want to lay too heavily on them if they have got the support of the Treasury already.

Senator BYRD. They may want to say as little as possible.

Senator PACKWOOD. That is correct.

Mr. HALPERIN. I would like to say just one brief word about S. 2904. That is intended to eliminate rather complex tax adjustments which are required when tires are returned and there is a price

adjustment due to the tire warranty. We have been dealing with that matter for at least the last 4 years, and probably a good many years before that.

When we discussed this in the last Congress, we suggested rather than trying to fix up the method of computing the warranty that we just reduce the tax to begin with, and not have any tax refunds at a later point. We have been working with the industry on that for a couple of years, and I think this is an unusual bill.

It does not involve any revenue loss. It involves administrative savings for both the industry and the Internal Revenue Service. We urge that you enact it so that we can get this matter behind you.

S. 2805 involves the question of valuation of inventories, and the issue is the time for compliance with Treasury regulations and the Supreme Court decision relating to so-called excess inventory.

The bill would postpone compliance until 1980. It is claimed that the IRS efforts to obtain compliance with the Supreme Court decision for 1979 is retroactive. We reject that charge and strongly oppose the bill. What is involved in this bill is a decision rendered by the Supreme Court in January 1979 and the question of whether taxpayers have to comply with that decision.

The merits of the decision are not at issue. I have detailed it in my testimony, and I will be prepared to answer questions on it if you desire. The issue is not really the merits. The question is when taxpayers should be required to comply with the Supreme Court decision.

Really, the question that you need to consider is how, when we have a regulation that goes back 50 years, and we have a Supreme Court decision rendered in 1979, requiring compliance with that decision be considered retroactive.

It seemed to the IRS that once the Supreme Court ruled almost a year and one-half ago that under our self-assessment system, taxpayers using a method that they knew to be wrong have an obligation to change it to that method permitted under the Supreme Court decision.

No one denies that the IRS upon audit could come in, for any open year, and require taxpayers to comply with the Supreme Court decision. That could be back in 1975, 1976, or even earlier if those years are still open.

Senator BYRD. You say that Treasury takes the position that it can or cannot?

Mr. HALPERIN. It can do that, and I don't know of anybody who denies it. I think even the supporters of the bill would agree with that position.

Senator BYRD. You say that the Supreme Court set aside a provision that has been law for 50 years?

Mr. HALPERIN. The Supreme Court agreed with a provision that has been in the regulations for 50 years. The Supreme Court upheld the regulation and said that it was valid.

Senator BYRD. So you could go back 50 years, then, is that it?

Mr. HALPERIN. If 50 years were open, we could go back 50 years.

Senator BYRD. There is no statute of limitations, or anything like that?

Mr. HALPERIN. There would be a statute of limitations in most cases. We could only go back to years that were still open under the usual statute of limitations.

Senator BYRD. What is that?

Mr. HALPERIN. That would be 3 years, unless extensions of time have been filed. That is not in dispute. The issue is, what do taxpayers have an obligation to put on their tax return.

People are asserting that even though they know that they are using an erroneous method, and even though they know that if the IRS audited their return they would change and preclude that erroneous method, that they still have the right to file a tax return using that erroneous method, and wait and see what happens.

This is a very peculiar position under our self-assessment system. The assertion that the mere requirement of filing a correct tax return makes the rules retroactive must be based on the assumption that the audit requirement does not impose any serious burden, that the IRS does not have sufficient agents to catch them all, and that they have no obligation to tell us that they are filing a wrong return.

We have now taken a position—I will come to it and try to explain what has happened—which really eliminates their opportunity to file an incorrect return, and that somehow that in itself has made the rule retroactive. The taxpayers' position is based on a rather technical point.

They are saying that what they were doing in not following the IRS regulations was using a method of accounting, and a method of accounting may not be changed without the consent of the Internal Revenue Service. The taxpayers have asserted that even though the Supreme Court announced the decision in 1979 that said the method of accounting they are using is erroneous, they do not have an obligation to ask the IRS for consent to change.

There is an article in the Wall Street Journal this morning, which I will submit for the record, which indicates that some practitioners even carry this much further. One individual was quoted in that article as saying that if he knows a particular client is using an inventory method which basically is valuing all inventory at 80 percent of cost that that is a method of accounting, and even if he knows about it, he can continue to let that client file tax returns using that method, and has no obligation to notify the Internal Revenue Service, or to request a change of accounting method.

[The article referred to follows:]

[From the Wall Street Journal, Aug. 4, 1980]

LITTLE GUYS CHEAT ON INVENTORY TO "HIDE" GOODS, EVADE TAXES

(By Sanford L. Jacobs, Staff Reporter)

Cheating on inventories is a common way for small businesses to chisel on their income taxes. Small-company owners "catch on very quickly," says Jeffrey J. Sands, a small-business specialist with Peat, Marwick, Mitchell accountants. "The lower the inventory, the less tax they're going to pay."

Understating year-end inventory is a simple and relatively safe though improper—means of reducing a profitable concern's taxes. When goods are sold, their cost is deducted from sales revenue to determine taxable profit. Falsely reducing inventory has the effect of falsely increasing that deduction because the "hidden" goods are presumed to have been sold. In some quarters, it's known as "taking a haircut." A New York accountant describes inventory cheating as "one of the dirtiest areas

we deal with." The practice is so widespread that many accountants feel compelled to scrutinize inventory habits of all prospective small-business clients.

Inventory cheating is rare among large corporations. They can afforded the complicated accounting procedures usually needed to take advantage of a legal inventory-tax benefit: last-in, first-out, or LIFO. "The current complexity in the use of LIFO effectively denies small business its benefits," says Daniel Halperin, the Treasury Department's deputy assistant secretary for tax policy. Adds Lee J. Seidler, a New York University accounting professor: "Cheating is the little guy's LIFO."

The Internal Revenue Service acknowledges that inventory cheating goes on in small companies, though the agency professes to have no idea how prevalent the practice is. A recent IRS study found that of the audits of returns for a year for firms with assets of $1 million or less, 25 percent resulted in inventory adjustments.

Much of the responsibility lies with the IRS, argues J. Fred Kubik, a partner in a Wichita, Kans., accounting firm. "Historically," he says, "the IRS wasn't willing to monitor inventories." An IRS official who disputes that view says inventory cheating isn't as big as other tax problems among small companies.

"There's more misapplication of the law in travel and entertainment," the official says, "We probably find more frequently that owners had the business pay personal expenses they shouldn't have had paid."

Accountants disagree. They're convinced that more taxes can be avoided by inventory manipulation than by expense-account shenanigans. A New York garment maker, for example, evades a sizable amount of income tax by undervaluing his firm's inventory by 20 percent on the tax return. "He hides about $500,000 out of a $2.5 million inventory," says an accountant who knows the owner of the firm but doesn't audit its books.

The inventory manipulation reduces the garment maker's taxable income by the same amount. At a 46 percent tax rate, the owner evades federal income taxes of $230,000. His accountant is aware of the scan and goes along, collecting an unusually high annual fee of $50,000.

Most Certified Public Accountants say they won't knowingly endorse inventory cheating. "If we're giving someone an audited statement," says a partner in one of the Big Eight CPA firms, "he's going to have to clean his house." That means disclosing past inventory sins, he says, but it needn't involve confessing to tax fraud.

The IRS often allows a business 10 years to pay the added taxes that result from adjusting tax returns to reflect proper inventory values. Dennis Serlen, a partner at Arthur Young & Co., says the IRS "is usually just happy to find out about it."

Some CPA firms admit going along with aggressive tax-avoiders. "You say it's hiding 20 percent of the inventory, but I say it's a proper method," asserts the chief partner of a medium-sized CPA firm in the Midwest with about 1,000 clients. "It's valuing the inventory at 80 percent of cost." If a business owner has consistently undervalued inventory, the CPA firm would take him as a new client—without insisting he stop the practice.

Why? IRS rules prohibit changing accounting methods without the agency's approval, the Midwestern accountant says. Therefore, he reasons, a business that uses an improper method must continue to do so. "It needn't be proper," he stresses, "but it must be consistent."

Even computerizing a firm's bookkeeping doesn't necessarily put an end to inventory cheating. A New Jersey supplier was concerned that the computer system he wanted to use would give the IRS an easy way to discover that his inventory was undervalued. But a computer programmer reassured him by devising a system to list the entire inventory accurately and give the company effective controls over its merchandise. He also programmed the computer to understate the inventory's total value by $70,000. To detect the discrepancy, an auditor would have to add the values of thousands of items manually.

When it's time to pay income taxes, business owners usually want to report the smallest possible amount of profit. But when they need to borrow, they generally want profits and assets to look fat, so there's a temptation to inflate year-end inventories on financial statements going to the bank.

The New York garment maker who hides $500,000 of inventory at tax time uses a different fiscal period for financial statements to his bank. After writing down the inventory as of Dec. 31, he writes it up six months later when the financial-statement year ends. In this way, he underplays the IRS and impresses his banker. Some describe that kind of inventory as WIFL—Whatever I Feel Like.

Mr. HALPERIN. The purpose of the rule to require Internal Revenue Service permission was to allow the IRS to monitor any changes, to make sure that people were changing to appropriate

methods, and that there was not an omission of income involved in going from one method of accounting to another.

It certainly was an unintended result, if it is a result at all under that rule, that the people can just not request permission, and use it to knowingly shield the use of improper methods. We reject the idea that taxpayers can continue to use a method of accounting which they know is improper, which the Supreme Court has told them that it is improper, and which they know is subject to change on audit.

We need to consider the problem on an overall basis. What the IRS did in these circumstances was to give people overall permission to change. The IRS announced that everybody had permission to change. This meant that people no longer had an excuse for using an improper method, and they had to adopt what is known as the proper rules.

We know of no procedural problems in complying, or any unreasonable return preparation. We think the taxpayers have ample opportunity to correct their tax return for 1979, and use the method that they knew since January of 1979, under the Supreme Court decision, was required.

The issue here arises because the IRS did not grant this permission to change until the announcement in February 1980, and somehow people treat this as retroactive. As I have indicated earlier they have always been aware of the fact that they were subject to change on audit, and the only thing we did was to tell them that they had to file a correct return for 1979, and not wait and see if they, in fact, will be audited.

We assumed that people would file a correct return for 1979 anyway, and we have removed any argument that people have for failing to do so.

Senator BYRD. As I understand it, there is only 1 year involved under Senator Nelson's proposal. Is that correct?

Mr. HALPERIN. That is correct, Mr. Chairman.

Senator BYRD. Senator Nelson's proposal is that insofar as 1979 is concerned, that the old ruling would prevail.

Mr. HALPERIN. I think that it is that insofar as 1979 is concerned, taxpayers can in filing their tax returns, continue to ignore the IRS regulation and the Supreme Court decision, and continue the erroneous practice that they have been following in the past.

Senator BYRD. But it affects only the 1 year. Is that correct?

Mr. HALPERIN. That is correct.

Senator BYRD. The IRS did not promulgate its procedure until February of 1980.

Mr. HALPERIN. That is correct.

Senator BYRD. That is what gave rise to this bill, I assume.

Mr. HALPERIN. That is right, Mr. Chairman. People are saying that if we expected them to follow the Supreme Court decision, we should have told them earlier. I think that that is a peculiar position. They knew what the right rules were. They knew what they were doing was wrong. They knew that what they were doing was subject to change upon audit. All they are maintaining is that they had a right to file a knowingly erroneous return and wait and see if they got caught. We reject that as an interest that is worthy of protection.

All we told them was that they had permission to file a correct return. We think that that should always have been understood as the right path to follow. There is no serious problem that we know of in filing a correct return for 1979. If people are going to have to change on audit anyway, we don't see the merit of the argument that they are making.

Senator BYRD. Your contention is that since the *Thor Power Tool* case was decided in January of 1979, the taxpayers had adequate time to revise the inventory write down.

Mr. HALPERIN. They had adequate time to compute the inventory, yes, Mr. Chairman.

Senator BYRD. What will be the effect on the taxpayers if the IRS ruling stands? Will it require taxpayers to revise completely their 1979 tax return?

Mr. HALPERIN. They would have to adopt an inventory method for 1979 that would be in accordance with the *Thor Power* decision.

Senator BYRD. You mean that they would have to rework their tax return; is that right?

Mr. HALPERIN. They have known since February what procedure they would have to follow. Most taxpayers do not file a tax return for the calendar year until September 15.

Senator BYRD. Those who have filed, they would have to file a revised version, wouldn't they?

Mr. HALPERIN. Anybody who filed a return earlier in the year would have to file a revised return; that is correct.

Senator BYRD. You say most taxpayers for 1979 do not file until September of 1980?

Mr. HALPERIN. That is correct. Corporation tax returns are due on March 15. There is an automatic 3-month extension which can be obtained, and an additional 3 months with the permission of the IRS. Most corporations obtain extensions for the full 6 months and do not file until September 15.

Senator BYRD. Those who do not seek an extension, what happens there?

Mr. HALPERIN. Those taxpayers who have filed their tax return, they have been granted, under the IRS procedure, the right to file an amended return up through September 15 to comply with the *Thor Power* decision. We have received a number of tax returns from people who have already complied with the decision. It is not a difficult problem as far as we can tell.

Senator BYRD. If they write down the inventory to a low value, that helps them that 1 year. But if they sell it at a higher price later on, then that is picked up, isn't it?

Mr. HALPERIN. That is correct.

Senator BYRD. Senator Packwood.

Senator PACKWOOD. You are going on with your testimony, aren't you?

Mr. HALPERIN. Yes, sir.

Senator PACKWOOD. I have questions when he gets to page 34, but I will wait until he gets there.

Senator BYRD: Do you want to go to the next item?

Mr. HALPERIN. I might say, Mr. Chairman, your last question indicated the assumption that what we are talking about is timing. What is involved in the *Thor Power* decision is the question as to

when you can take account of what might be unrealized losses on inventory.

Our normal system, of course, for tax purposes is that if property goes up in value, and you have an unrealized gain, you do not pay any tax at that point until you sell it. Similarly, when property goes down in value, you can't take account of the losses until you sell it.

We do have a special rule for inventory that allows you to value it at lower of cost or market. Market is normally the replacement cost, what it would cost you to go out and buy it today, if that is lower than what it cost you when you originally purchased it, or it might indicate that you have scrapped it, or you are actually offering it for sale at a lower price.

What the taxpayers were doing in *Thor* was saying: We have too much on hand. We make a lot of replacement parts. We have 1,000 replacement parts. We don't think that we can ever sell 1,000 at the price we are now offering them for. We think that we can sell only 400 or 500 at that price. We are going to write down the other 500.

The position that the IRS took, which was upheld by the Supreme Court, is that it is too subject to manipulation. We need objective evidence of the decline in value. You cannot take an unrealized loss unless there is some of that objective evidence.

Obviously it is timing, but it is an important administrative rule, and it is consistent with our normal practice of not looking at either unrealized gains or unrealized losses.

Senator BYRD. Thank you.

Mr. HALPERIN. On S. 2967, the estate and gift tax changes, we welcome the initiative of the subcommittee in holding hearings on this important subject. We believe that a comprehensive consideration of the estate and gift tax is long overdue.

We do need an identification of the normative structure of the estate and gift tax, and an analysis of the cost of special provisions, for example the special farm valuation which we put in for other purposes so that we can tell what it is costing us for this benefit.

We need to know more than we do about the actual impact of the estate and gift tax on ownership of closely held businesses, and what impact the tax has on actually causing the transfer of such businesses.

We have begun to work on these issues, and we believe that the initiative shown by this committee and the information developed at these hearings will give impetus to our work in this area.

We do believe that we need an overall review of the policy and structure of the transfer tax before any change is made. We need to look at the supposed burden under the present law, the extent to which these nominal burdens can be and are being avoided under present practice. We should consider whether it is appropriate to eliminate the many existing loopholes in our transfer tax system.

We also need to consider the question of how progressive the tax should be, if we are going to consider the question of the increase in exemption level. We must look at the overall progressivity of the combined effect of the income and estate taxes. At the moment, a large part of that progressivity comes from the estate tax. We must

consider to what extent it is appropriate to reduce the overall progressivity of our tax system.

I might point out two things. Our estimates indicate that if you do raise the exemption level, as proposed in this bill, that less than one-half of 1 percent of decedents dying each year would be subject to the estate tax. We need to carefully consider whether that is an appropriate cut-off point for a tax of this type.

I also might point out that because of the changes made in the repeal of carryover basis, we already have made a significant departure from the progressivity assumptions that were made when the estate tax was last changed in 1976. Many of the liberalizations in the law at that time were based upon the assumption that they were a quid pro quo for the increased taxes caused by the carryover basis rules.

We also need to consider in determining the issue of progressivity the impact of the higher annual exclusion for gifts, and the question of the unlimited marital deduction. We now allow people to give away up to $3,000 per year to any one donee without being subject to a gift tax.

We really think that that $3,000 limit was not based so much on how much it was reasonable to allow people to give away each year, but really at what point it was reasonable to expect them to start accounting for gifts. We obviously don't want people to pay gift taxes on minor birthday presents to their children.

Therefore, when we focus on that issue, it is, I think, an administrative question as to what point gifts are large enough so that people should be aware that they are subject to a transfer tax requirement. In that connection, we may have to focus on our definition of support. If, in fact, things like paying college tuition are really considered gifts, then it is appropriate for the exemption level to be higher because we do not want people to be including those things——

Senator BYRD. What is the Treasury ruling on that?

Mr. HALPERIN. I believe that it probably considered a gift, and not support. Most taxpayers like that result because it gives them a good income tax result. They can set up a trust, for example, to pay college tuition for their children and not be subject to income taxation on the income of that trust. So we do have a conflict here.

Senator BYRD. Let me ask you, to see whether I understand what you are saying.

If a parent pays the college tuition for a son or a daughter, whatever it might be, $8,000, that is subject to a gift tax under the present laws?

Mr. HALPERIN. We do go by State law, but my understanding would be that there is no obligation on the parent to pay that under most State laws, therefore it would be a gift. I would suspect that that is mostly ignored.

Senator BYRD. But under the law the Government could require that tax be paid; is that what you are saying?

Mr. HALPERIN. I would think so, Mr. Chairman.

Senator BYRD. You think so?

Mr. HALPERIN. I believe, assuming that it is beyond the exemptions that are permitted. If it is more than $3,000 per year, which it will be, the Government could require a return to be filed. If the

parent's lifetime credit is exceeded, the Government could require a tax to be paid.

So, I think, in focusing on the increased exemption, we need to focus on the question of support, and perhaps redefine what we consider support not only for estate tax purposes, but also for income tax purposes as well.

On the issue of the unlimited marital, I might point out that the decision that we made in 1948 to allow a 50-percent marital deduction really was not based on the assumption that the husband and wife were one taxable unit for transfer tax purposes, but was based on an effort to equate the treatment between community property States and common law States. Otherwise, you had a situation where if the husband produced the entire taxable estate, upon the husband's death in the community property States one-half was subject to tax, while in the common law State it was all subject to tax.

The marital deduction went in in 1948 to change that rule. It was not based on any theory that the husband and wife were one taxable unit. That is, however, a possible approach, and if we are going to go the route of an unlimited marital we need to determine all the ramifications of that approach.

I might point out that in 1969 the Treasury did issue a proposal for an unlimited marital deduction. It had with it many other changes in the estate and gift tax law to go along with it. It included some technical changes in when gifts were considered to have been made, and the definition of a qualified interest for the marital.

We think the issues raised in the 1969 Treasury report are worthy of consideration if you are going to get into the question of the unlimited marital deduction.

Senator BYRD. I am not sure just what are the advantages and disadvantages of that.

Mr. HALPERIN. In some cases it is not an advantage. If, in fact, you have an estate where the surviving spouse is likely to use up all the assets prior to death, then the unlimited marital, of course, will mean that there will be no tax on either the death of the first, or the death of the survivor. Today you can transfer $425,000 to a surviving spouse without any transfer tax liability.

People who get into a larger estate are not necessarily interested in an unlimited marital because they would like to divide the taxable estate between the two parties, so that they can get the advantage of the lower rates. If the transfer from the husband to the wife would be totally tax free, and the wife would die a few years later, the overall estate tax burden would be much larger with an unlimited marital.

So one of the proposals that was made in 1969 is that it be elective, that the parties have the right to decide whether they wanted to take advantage of an unlimited marital or not, and that is certainly something that needs to be considered if you get into this issue.

Senator BYRD. Wouldn't that be done under Senator Nelson's bill?

Mr. HALPERIN. My understanding was that it was not elective.

Senator BYRD. My understanding is that it is elective. I think it would be probably very undesirable to have it not elective.

Mr. HALPERIN. That is certainly true, Mr. Chairman. It certainly should be elective.

Senator BYRD. The way you read the bill it is not elective?

Mr. HALPERIN. That is what I was advised, but I will go back and take another look.

Senator BYRD. I think you have to go back and take another look. If you are right, I think that needs to be changed.

Mr. HALPERIN. We certainly all agree that whatever it does say, the intention would be to make it elective.

Senator BYRD. What would be the disadvantages to the Government to take the proposed bill language, assuming that it is elective?

Mr. HALPERIN. Presumably there would be some reduction of the estate tax burden in cases where people transfer more than $425,000 to a surviving spouse, since you can now transfer $425,000 tax free under existing law. Those who might want to transfer $500,000, $600,000, or $700,000 to a surviving spouse might have a reduction in their overall estate burden.

Assuming that we are going to keep the estate tax at approximately the same level the question is: Where does that burden go, and that burden goes to people who are not married, or who would rather transfer their property to others?

Senator BYRD. Do you favor or oppose that provision?

Mr. HALPERIN. I think, Mr. Chairman, there is a lot to be said for it. I think it depends on what we do with the system. I think one question that we have to decide is: What is the total amount that we are going to collect in estate and gift taxes; second, how are we going to allocate that burden among people in various circumstances?

We don't necessarily oppose an unlimited marital, but we have to look at it in the context of an overall change in the estate and gift tax. We have not come to a definite conclusion on it in the context of the present system, or in the changes made in Senator Nelson's bill.

Senator BYRD. Does that conclude your testimony?

Mr. HALPERIN. In general, Mr. Chairman, we have indicated our position on the several provisions of S. 2967, and we welcome the opportunity to begin the discussion with you and other interested parties on this issue.

That does conclude my testimony.

Senator BYRD. Thank you, sir.

Senator Packwood.

Senator PACKWOOD. On page 34 you make reference to the active management provision, and then you say: "Final regulations were published on July 31, 1980". Then you say: "For example, the proposed regulations did not address the issue of how material participation would be determined where the farmland was timberland. The final regulations provide specific guidance with respect to this matter."

What change is there? I am not familiar with the final regulations.

Mr. HALPERIN. I will ask Mr. Melton to respond to that question.

Mr. MELTON. Senator Packwood, we have revised some of the examples and added to others to describe material participation. We have added a rather lengthy example describing how the standard can be satisfied with respect to an individual who owns a tree farm, and who participates in the operation of the tree farm.

Senator PACKWOOD. You have not changed the regulation. You have simply added an example.

Mr. MELTON. That is correct.

Senator PACKWOOD. Tell me the example so that I understand exactly what it is.

Mr. MELTON. The example involves an individual who owns a tree farm and who has a manager who is involved with the operation of the tree farm. The individual, however, participates in the decisions as to the operation of the tree farm in an on-going manner, that is, the pruning, cutting and so forth. He also takes part in the decision as to when overall cutting will be done to provide stumpage.

The example concludes that this constitutes material participation. We give a positive example of how an individual can satisfy the requirement with respect to a tree farm.

Senator PACKWOOD. Now, if an individual owns a tree farm, and the best forestry advice is that for 2 or 3 years it does not require any management at all, just to leave it alone. Does that qualify as material management, or active management?

Mr. MELTON. Senator, I think in the example if the individual was aware that the best forestry advice said nothing should be done on the farm, that would be sufficient. There is another provision in the final regulations which indicates that in a situation where there is seasonal activity on a farm, then as long as there is material participation during the season when activity is necessary, material participation can be satisfied.

So I believe that the combination of those statements in the final regulations would answer your question in the affirmative. Yes, there can be material participation although nothing is actively done.

Senator PACKWOOD. I want to make sure that this is on the record again.

Nothing may need to actively be done on the land for 2 or 3 years.

Mr. MELTON. I believe the statement in the example would say that the individual who owns the tree farm must keep aware of whether that is continuing to be the advice.

Senator PACKWOOD. Whether it is what?

Mr. MELTON. He must be aware as to whether the original advice, let us say, in 1980 is to do nothing for 3 years.

Senator PACKWOOD. He must be aware as to whether nothing has been done?

Mr. MELTON. No, sir, that is not what I meant. He must be aware as to whether that original advice in 1980 is continuing to be the appropriate advice.

Senator PACKWOOD. I understand that. He cannot get advice in 1980 to do nothing, and leave it for 20 years and say that the last advice he had was to do nothing.

Mr. MELTON. Correct.

Senator PACKWOOD. But to the extent that the valid advice is that every other year he needs to thin it, and every fifth year you need to do something to it—and that is all it takes—that would qualify for active participation?

Mr. MELTON. I apologize, I don't have the example with me, or I would be able to look more closely at the terms of the example. However, in working on the example, it was our understanding that there would be ongoing advice from those who are involved in foresty.

Senator PACKWOOD. I understand that ongoing advice part. I want to know if the ongoing advice does not require you to do anything for 2 years, if you are going to qualify.

Mr. MELTON. The answer is yes.

Senator PACKWOOD. Could you send me both the final regulations, and your example?

Mr. MELTON. Yes, sir, Senator. The example is included in the final regulations, and we will be glad to send one to your office.

Senator PACKWOOD. Thank you.

I have no other questions, Mr. Chairman.

Senator BYRD. Thank you, gentlemen.

[The prepared statement of Mr. Halperin follows:]

STATEMENT OF DANIEL I. HALPERIN
DEPUTY ASSISTANT SECRETARY FOR TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE
August 4, 1980

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: Sections 4 and 5 of H.R. 7171, providing special rules with respect to transferor railroads to ConRail which are members of an affiliated group of corporations filing a consolidated return; S. 2775, relating to the tax treatment of contributions or accruals to nonqualified pension plans maintained for nonresident aliens; S. 2818, relating to the taxation of mutual or cooperative telephone and electric companies; S. 2805, delaying the effective date of two IRS pronouncements issued to implement the Supreme Court's decision in Thor Power Tool Co. v. Commissioner; S. 2904, reducing the manufacturer's excise tax on new tires and correlatively eliminating credits or refunds on certain warranty adjustments; and S. 2967, relating to estate and gift taxes.

After setting out a summary and the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

Summary

Section 4 of H.R. 7171 would provide that, for purposes of including in income amounts in an excess loss account with respect to a transferor railroad to ConRail, a deemed disposition of the railroad's stock which is based on a determination that the stock has no value will not occur until the valuation decision of the special ConRail court becomes final. Section 4 is intended to benefit the Norfolk and Western Railway Company. Section 5 of H.R. 7171 would provide that, where an excess loss account with respect to a

ConRail transferor is included in income of a parent, losses which are generally subject to revival under the ConRail provisions will be allowed to the subsidiary transferor railroad to offset income arising from the ConRail transfer. Section 5 is intended to benefit the Erie Lackawanna Railway Company, a member of the affiliated group of corporations of which the Norfolk and Western Railway Corporation is the parent. The Treasury Department does not object to sections 4 and 5 of H.R. 7171. However, Treasury is concerned about the amount of time and effort which has been devoted to special tax legislation relating to the ConRail transfer. We do not believe it is appropriate to spend more time on this matter at least without a full re-evaluation of the tax consequences of the ConRail reorganization.

S. 2775 would provide that deductions for contributions or accruals to foreign pension plans maintained for nonresident aliens would be determined under general U.S. tax standards rather than under the more specific rules of section 404 or under the standards of foreign tax systems. Treasury generally supports this bill but raises certain additional issues for the Subcommittee's attention.

S. 2818 relates to mutual or cooperative telephone and electric companies. It would exclude from the unrelated business tax (UBT), income from the rental of the right to attach wires to its poles, would disregard this pole rental income for purposes of the 85 percent membership income test, and, in the case of a telephone cooperative, would similarly disregard income from the sale of "display listings", such as listings in yellow page directories. The Treasury Department does not oppose exempting pole rental income from the UBT. However, Treasury has reservations about excluding this income and display listing income from the 85 percent test.

S. 2805 would delay until taxable years beginning after December 31, 1979, the effective date of two IRS pronouncements, Rev. Proc. 80-5, and Rev. Rul. 80-60, issued to implement the Supreme Court's decision in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), involving the proper method of accounting for excess inventory. The Treasury Department strongly opposes S. 2805.

S. 2904 would reduce the manufacturer's excise tax on new tires and correlatively eliminate any credit or refund for warranty adjustments (after a two year transition period). The Treasury Department supports S. 2904.

S. 2967 would make a number of changes to the estate and gift tax provisions. The Treasury Department believes that some of these changes may be appropriate in whole or in part in some context. However, we are not in favor of making such piecemeal changes until their structural and policy ramifications have been fully examined in the context of an overall review of transfer taxes.

* * *

Sections 4 and 5 of H.R. 7171: Special Consolidated Return Rules for ConRail Transferors

Sections 4 and 5 of H.R. 7171 provide special rules for certain railroads that participated in the ConRail reorganization. In 1976, Congress enacted tax legislation tailored specially to the particular form taken by that reorganization. Some of the tax consequences of the reorganization could not be determined, however, unless the consideration received by the railroads for the property transferred, which included ConRail stock and certificates of value issued by the United States Railway Association, were valued. The value of these certificates, in turn, depended upon a valuation of the railroad properties transferred. The valuation of those properties is to be determined ultimately by a special court created for this purpose. The special tax provisions enacted by Congress in 1976 allow certain losses of the transferor railroads to be, in effect, held in suspense until a valuation of the certificates is made.

In some cases, the transferor railroads were subsidiaries of larger corporate entities. Under the complicated rules dealing with tax returns of a consolidated group of corporations, if a subsidiary corporation's stock becomes worthless at any time, the parent corporation may be required to include in income certain losses of the subsidiary that had previously been reflected in the tax return of the consolidated group. This reflects the fact that the parent will not bear the burden of the loss. However, the worthlessness of the subsidiary's stock may depend on the value of the ConRail certificates.

Section 4 of the bill would provide that, to the extent that the worthlessness of a subsidiary's stock depends on a determination of the value of the certificates of value, any determination of worthlessness is postponed until the value determination by the special court becomes final.

Section 5 of H.R. 7171 covers another special problem arising from the application of the ConRail provisions to consolidated returns. This section provides that, to the extent a parent corporation takes amounts into income to reflect higher losses of subsidiaries that were used in the group's consolidated return, the subsidiary is permitted to use those losses in its own separate return. However, the only losses which can be so used are those equivalent to the losses which the ConRail provisions generally permit to be revived and used against income from certificates of value and other specially designated income.

Because the ConRail provisions have, from the start, reflected some willingness to tailor the tax treatment of the transaction to the special needs of the transferor railroads, Treasury has not objected to this bill in its present form. However, this is not the first time that transferor railroads have requested special treatment for transactions relating to the ConRail reorganization after the original special provisions for ConRail were put into the Code. If additional requests are made in this area, we expect to look closely at all the tax consequences of the ConRail reorganization in evaluating the need for new legislation in this area.

S. 2775: TREATMENT OF CERTAIN NONQUALIFIED DEFERRED COMPENSATION PLANS FOR NONRESIDENT ALIENS

S. 2775, relates to retirement and similar plans maintained for non-resident aliens.

The basic issue is whether the U.S. tax treatment of contributions to foreign pension plans maintained for non-resident aliens should be the same as the treatment given contributions to U.S. pension plans. Treasury generally supports this bill.

The problem arises in two contexts. First, foreign income may be directly taxed by the United States as in the case of a foreign branch of a United States company, certain foreign operations connected with a U.S. trade or business of a foreign company, or through subpart F of the Code which treats certain income of controlled foreign corporations (CFC's) as earned by U.S. shareholders. The U.S. must determine whether and how such income should be reduced by costs attributable to foreign pension plans.

Second, for foreign subsidiaries, the amount of foreign pension expense is important in determining the amount of foreign taxes which may be creditable against the U.S. tax. Code section 902 is designed to avoid international double taxation on profits of a foreign subsidiary owned by more than 10 percent corporate shareholders. The U.S. shareholder is deemed to have paid a portion of the foreign income taxes equal to the portion of the "accumulated profits" of the subsidiary which were distributed. In determining the portion distributed, it is essential to know the total "accumulated profits" which in turn depends upon the amount of pension expenses which can be taken into account.

Accumulated profits has consistently been viewed in terms of United States rather than foreign tax standards. However, whether contributions or accruals to foreign pension plans reduce accumulated profits will in most cases depend on whether the "U.S. standard" applied is the general tax accrual standard or, alternatively, the special U.S. standards under section 404 for contributions to employee deferred compensation plans.

One significant feature of the United States system is the requirement for actual cash transfers. No deduction is allowed for accrual of liabilities, even in cases where all events have occurred which fix the liability to a specific beneficiary and the amount of the liability is known. There are two considerations supporting this rule generally. First is the belief that the security of the promised benefit requires a transfer of funds to an independent fiduciary to be held for the exclusive benefit of employees and retirees. Employees should not have to compete with general creditors of the employer. Secondly, because the employee is on the cash method, if general accrual rules were followed there would be a substantial mismatch in the time of the deduction by the employer on the accrual method and the taxation of the benefit to the employee. Section 404 is designed to eliminate this mismatch except in the case of qualified plans which serve the public purpose of benefitting a broad cross-section of employees.

Of course, with respect to non-resident aliens working outside the U.S., the latter concern is not relevant since they would not be paying a United States tax on their income. With respect to the first concern, other nations have reached conclusions for their own residents which differ from ours. For example, Germany and many other countries have chosen a pension system designed to increase capital investment in the

employer. These countries have created rules strongly favoring accrued but unfunded pension obligations, supported by a separate insurance system to protect retirees against unanticipated business declines.

It seems inappropriate for a United States rule to be applied worldwide to foreign persons not resident in the U.S., particularly in the face of different judgments reached by other countries. It is clear that our tax rules are at issue here rather than ERISA generally; the general funding requirements contained in Title I of ERISA (and thus generally applicable whether or not a plan is tax qualified) are subject to an exclusion for plans maintained outside of the United States primarily for the benefit of persons substantially all of whom are non-resident aliens.

There are in addition other issues which arise even when there is separate funding. Under section 404 such cash transfers would not be deductible unless either the plan was qualified or specific employees had a vested interest in the amount contributed. There are certain exceptions to the strict qualification standards. Minimum standards for participation in qualified plans need not be applied with respect to employees who are non-resident aliens having no U.S. income. Furthermore, the general principle which prohibits discrimination regarding contributions or benefits in favor of officers, shareholders or highly compensated individuals, can be applied without consideration of employees who are non-resident aliens. However, there are many other provisions which could prevent a plan from meeting the appropriate standards for qualification and therefore deductibility even though all participants were non-resident aliens. Such provisions include, for example, the requirement for joint and survivor annuities, vesting rules contained in section 411 and the merger and consolidation rules aimed at protecting the integrity of plans involved in mergers or spin-offs.

Even assuming that each of these other qualification standards apply and are met, section 404 contains an elaborate set of special deduction rules which also have underlying social goals to some degree. The deduction rules with respect to profit sharing plans are more restrictive than the deduction rules with respect to money purchase plans or defined benefit pension plans. Because of this difference the system favors certain plans, i.e., those which do not have the discretionary contribution element of a profit sharing plan. Furthermore, special deduction limits apply to

plans maintained by proprietorships, partnerships and Subchapter S corporations. With respect to defined benefit plans the annual cost of the plan must be measured in accordance with the actuarial rules used by the plan to satisfy the minimum funding standards under section 412. The section 412 rules have been designed to some extent with the specific purpose of denying certain actuarial methods which, although arguably accurate in their ability to measure and allocate plan costs between separate accounting periods, leave the employee in a more precarious position with respect to the adequacy of the funding of the plan.

We see no reason to compel a foreign subsidiary or a foreign branch employing non-resident aliens to comply with those U.S. deduction rules that are motivated by U.S. social policy concerns rather than general U.S. tax policy with respect to the appropriate calculation of taxable income for the period. It may, in fact, be frequently impossible for a foreign subsidiary or branch to comply with the U.S. rules because it may be bound by different rules of the jurisdiction in which it is incorporated or operating.

Thus, the bill permits both branch and foreign subsidiary operations to use rules which appproximate normal accrual rules for plans benefitting employees substantially all of whom are nonresident aliens. Accordingly, accumulated profits, earnings and profits, and taxable income may be reduced because of an accrued pension benefit so long as the obligation is absolutely and clearly fixed, even though a separate fund is not set aside.

With respect to those plans which are in fact separately funded a deduction is allowed under the bill for the amount set aside to the extent that it reasonably relates to the benefit promised and to the extent that the fund is not subject to reversion to the employer. The deduction is permitted whether or not the plan meets the detailed qualification standards of section 401 and whether or not the benefit is fully vested in the employee at the time the money is transferred. Of course, in both the unfunded and funded situations we believe that it is necessary to limit the deduction to amounts calculated under acceptable actuarial methods pursuant to generally accepted standards.

Treasury approves of the use of limits referring to generally accepted accounting standards applicable to U.S. businesses. Using those standards avoids additional complex computations; the generally accepted accounting principles

are already applied by the domestic parent corporation in developing consolidated financial statements. Generally accepted accounting principles for pension expenses are currently based upon the Accounting Principles Board Opinion No. 8, promulgated in 1968. The Accounting Principles Board is at present involved in a study which may revise the rules. However, there is no indication that such revisions would move away from the basic concepts of continuity and an appropriate recognition of expenses attributable to each period based on a recognized actuarial method. These principles apply whether or not cash is actually transferred to a separate fund. These rules also have an explicit provision prohibiting the immediate charge to expense for new increments of past service liability, which is one of the primary aspects of the detailed section 404 rules which aid in the appropriate measurement of taxable income.

Notwithstanding our interest in avoiding conflicts between U.S. and foreign tax systems, and the international double taxation that frequently results from such conflicts, we believe it would be unwise to determine the deduction with respect to foreign pension plans with specific reference to the amount deductible under the foreign income tax system. It is a matter of long-standing U.S. tax policy that determinations of U.S. tax liability should be based on U.S. standards rather than be dependent upon the ups and downs of foreign law. Reliance on foreign law would create a shifting standard of U.S. tax liability, dependent upon the incentives or disincentives of different countries. A further problem with relying on foreign standards is that the IRS would be required to become expert in the various foreign laws controlling pension plans. It would be extremely difficult for the IRS to keep current on and fully understand all the relevant and complex provisions of such laws. Finally, reliance on foreign law in addition to U.S. law would require the further complexity of carryback and carryover provisions to account for timing differences between the two systems.

To sum up, in the case of foreign subsidiaries and foreign branches we believe that more general rules should apply. These more general rules will not only avoid imposing U.S. social policy on totally foreign operations but, as a general matter, will allow U.S. taxable income and accumulated profits to more closely approximate foreign taxable income thereby avoiding timing problems or permanent distortions which tend to create international double taxation of income. Although we have not completed our study of this issue, it is possible that a substantially similar

result is reachable under current section 902. Thus, we would have no objection if these legislative amendments were made applicable retroactively in the case of foreign subsidiaries. However, as contrasted to the foreign subsidiary case, current law controlling the determination of taxable income for foreign branches clearly disallows a deduction for an unfunded accrual or a contribution to a plan not meeting the requirements of section 404. Thus, the legislation as it affects branches is definitely a change in current law and should apply prospectively only.

S. 2775 contains two additional provisions which need mention. The first is an amendment to section 312 of the Code which prescribes rules with respect to the earnings and profits of domestic corporations. The second amends section 679 of the Code which provides rules with respect to foreign trusts created by United States grantors that do not explicitly prohibit benefit payments to U.S. taxpayers.

The provision regarding section 312 is apparently intended to make certain that the earnings and profits of foreign corporations are reduced in accordance with the new rules provided by section 404(i). Earnings and profits and accumulated profits rules for foreign corporations generally follow rules applicable to the computation of taxable income of U.S. persons. Consistent with this general approach, and especially in view of the clearly expressed purpose of S. 2775, we believe an amendment to section 312 is unnecessary. Furthermore, an explicit amendment to section 312 may raise negative inferences that other standards are used to reduce accumulated profits under present law or that earnings and profits do not, in general, follow taxable income absent a statutory provision to that effect.

With respect to the effective date of section 679, we believe that the change should be made retroactive to 1976 (the effective date of that provision) because that section was not aimed at bona fide foreign pension plans, but rather at abusive tax haven shelter trusts.

I would like to raise with the Committee two final concerns with regard to this legislation. First, as a general matter, we believe that there are other significant and unsettled issues related to the computation of accumulated profits and earnings and profits under section 902 as well as under section 964. In particular, we are concerned that a year-by-year comparison of foreign taxes paid with accumulated profits may not accurately reflect the

actual effective rate of foreign taxes paid. We believe that in the course of reviewing this bill the Joint Committee staff should be urged to look closely at these related issues with a view toward developing other legislative proposals.

Secondly, we believe that, in developing rules for the accrual of unfunded pension obligations where the payment is to be made substantially in the future, we are moving into an area of the tax law which is somewhat unique. Because of the substantial deferral, the bill explicitly requires that the current accrual deduction measure the present value of the final benefit. This concept provides an appropriate matching of income and expense. In essence this provision charges to this year's expense a portion of the final pension payment, and charges to future years the remainder of the total payment. Although there are many ways of characterizing the amount, the difference between this year's charge and the total payment might be viewed as an increase in the amount to be paid as a result of the deferral of the payment beyond the current year, i.e., the year in which the benefit was actually earned.

The concern which we wish to raise regards the appropriateness of permitting this additional deduction over the remaining years in those cases in which the current accrual is actually set aside by the employer in a separate investment, which itself produces income that is either tax free or substantially tax free to the employer. For example, assume that the amount set aside in this year is $100 and that the benefit that this $100 will provide in 20 years will have a value at that time of $320. Under normal circumstances where the $100 remains invested in the working assets of the business that $100 produces income for the employer, and such income is included in the employer's taxable income. Thus, the increasing obligation as a result of the deferral is rightfully treated as an additional deduction. However, if the employer, who for this example we would assume to be a United States corporation, were to invest that $100 in the stock of some other unrelated United States corporation and receive dividends thereon, the applicable U.S. tax law would provide that those dividends are subject to an 85 percent dividends received deduction.

The question we raise is whether under such circumstances it is appropriate to allow a deduction in excess of the original $100 accrual. If the employer were to chose to separately fund his obligation to make the pension payment the $100 would have been placed in a separate trust,

and neither the income earned thereon nor the payments by the trust to the employee in excess of the original $100 contribution would be accounted for in the employer's income tax return. This result is, of course, different from the result obtained by the employer who is able to make a tax preferred investment and yet claim a full deduction for the total payments made to the employee upon retirement. Under that circumstance the deduction is not offset by added taxable income.

We have no specific conclusions that can be applied without undue complexity. We therefore do not urge that the bill be delayed, but we will continue to study this issue. We also urge others to do so. We may come back to this issue if it appears to be a serious problem or if a workable solution is developed.

S. 2818: TAX TREATMENT OF CERTAIN MUTUAL OR COOPERATIVE TELEPHONE COMPANIES

Under existing law mutual or cooperative electrical and telephone companies are exempt from tax if, among other things, 85 percent of their income is derived from their member-patrons for the purpose of defraying the cost of services provided to members. Legislation enacted during the last Congress provided a special exemption from the 85 percent requirement for income derived by a telephone cooperative pursuant to an interconnection agreement for long distance calls involving the cooperative's members.

S. 2818 would make essentially three changes to existing law. First, where an electrical or telephone cooperative derives income from the rental of the right to attach wires to its poles, the revenue would not be considered in determining whether 85 percent of the cooperative's income is from members. Second, S. 2818 would exclude such pole rental income from the unrelated business income tax. Finally, S. 2818 would disregard, for purposes of the 85 percent requirement, income derived by a telephone cooperative from the sale of "display listings," that is listings in yellow page directories (as contrasted with normal telephone listings).

The Treasury does not oppose exempting pole rental income from the unrelated business income tax. The Treasury does have reservations about excluding both pole rental and display listing income from the computation of that portion

of the cooperative's income that is considered to be derived from nonmembers.

The provision of the Code which may result in subjecting pole rental income to the unrelated business income tax was added with the Tax Reform Act of 1969. Before that Act rents from real property were excluded from unrelated business income, and rents from personal property also were excluded where the personal property was leased with real property. Under the 1969 change rentals from personal property are subject to tax even where real and personal property are rented together, if more than 50 percent of the rental is attributable to the personal property. For these purposes telephone poles are considered personal property. Thus, whether pole rentals are subjected to the unrelated business income tax depends in each instance on how much of the income is attributable to the right of way (real property) and how much to the pole (personal property), a fact that frequently is difficult to ascertain.

The rationale for subjecting exempt organizations to the unrelated business income tax is to prevent them from competing unfairly with taxable businesses. Consequently, most forms of "passive" investment income are not subject to the tax. While it is difficult to say whether income from pole rentals is similar to "passive" investment income, such rentals do not appear to entail competition with taxable businesses. Moreover, existing law would yield different results for different cooperatives depending on the relative values or costs of their poles and rights-of-way, a result that does not seem particularly sensible. Therefore, we see no reason why the pole rental income should not be excluded from tax.

Different concerns are involved with the 85 percent requirement that currently applies to cooperatives. While that requirement was probably designed to forestall the necessity for cooperatives to distribute all liquid reserves to their patrons, it operates to permit an exempt cooperative to earn up to 15 percent of its income from nonmember sources and apply the profits to subsidize service to member-patrons. Where the 15 percent requirement is fulfilled with passive investment income the cooperative may, under the unrelated business income tax rules, derive that income free of any tax. The cooperative thereby is allowed to subsidize its patrons' cost of service with pretax rather than tax paid dollars. To this extent, member-patrons of a telephone or electrical cooperative are extended benefits that are

unavailable to those who purchase utility services from investor owned utilities.

We are reluctant to see the Code amended in any way that substantially enhances the ability of telephone and electrical cooperatives to subsidize the cost of services to their member-patrons with tax free income. It is possible that exempting from the 85 percent requirement income from both display listings and pole rentals would have that result. This is not, as was the case with recent legislation involving long distance interconnection revenues, a situation in which it is not possible to ascertain the extent to which the revenues are derived from outside the membership. Since revenues from both display listings and pole attachments is identifiable as such we question exempting them from the 85 percent test.

To be sure, where there is an identity between the source of what is technically non-member income and the cooperative's membership -- as, for example, would be the case when a telephone cooperative derived pole rental income from an electrical cooperative with identical patronage -- our concerns to some extent would be mitigated. However, it is not clear to us how frequently such an identity will exist.

Our general reluctance to see the 85 percent requirement eroded is reinforced by two longer-range considerations. First, we do not think that the Congress should adopt legislation that would significantly facilitate the ability of exempt cooperatives to subsidize their patrons' cost of service with tax free dollars without reexamining the basis for the exemption itself. We understand that many exempt electrical coops have in recent years become utilities of very substantial size. We also understand that the General Accounting Office is currently engaged in a major study of the treatment of exempt electrical cooperatives. We think that study, when completed, would offer the Congress a desirable opportunity to review the continuing wisdom of this exemption.

Second, the Congress has, in recent years, moved towards a different and in our view more sensible scheme for taxing mutual benefit organizations such as electrical or telephone cooperatives. Under that scheme, which now applies to social clubs and homeowners' associations, the entity is exempt from tax on all amounts received from members but subject to tax on all income derived from outside the membership. Imposing

a similar scheme on other cooperative organizations would curtail concerns for allowing cooperatives to defray the cost of their patrons' services with tax-free dollars and also would eliminate concerns about whether a cooperative has or has not exceeded the existing 15 percent limit. We believe this would be a far more sensible solution to these problems.

S. 2805: Delay of Effective Date of Implementation of Thor Power

S. 2805 would delay the effective date of two Internal Revenue Service pronoucements issued to implement the Supreme Court decision in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, announced by the Court on January 16, 1979. Revenue Procedure 80-5 and Revenue Ruling 80-60 provide that taxpayers whose method of accounting for "excess" inventory is not in compliance with the inventory regulations and the Thor decision, must change to a proper method when they file their income tax return for their first taxable year ending after December 24, 1979, such as calendar year 1979. S. 2805 would delay the required compliance with the Thor decision until taxable years beginning after December 31, 1979, such as calendar year 1980. The Treasury Department strongly opposes enactment of S. 2805. We believe taxpayers can and should comply without delay with the longstanding Treasury regulations and the unanimous Supreme Court decision in Thor. Rev. Proc. 80-5 and Rev. Rul. 80-60 are not retroactive. The pronouncements do not change the law that was in effect for 1979 and for over 50 years. Affected taxpayers have had more than sufficient time in which to collect any necessary data to make the change. Before specifically addressing the background and provisions of Rev. Proc. 80-5 and Rev. Rul. 80-60, I believe it would be beneficial to first review the Thor decision.

The Thor Decision. In its unanimous 9-0 decision, the Supreme Court upheld the Commissioner's authority, under longstanding Treasury regulations, to deny a deduction for the write-down of "excess" inventory. Under section 471 of the Internal Revenue Code, taxpayers are required to keep inventories in a manner that conforms as nearly as possible to the best accounting practice in its trade or business and that most clearly reflects its income. The regulations, in general, allow the valuation of inventory at market if lower than actual cost. However, the regulations define market as replacement cost and provide that normal inventory can be written down below replacement cost only when it is actually scrapped or offered for sale at a lower price.

Consistent with generally accepted accounting principles, but contrary to the income tax regulations, the Thor Power Tool Company utilized scrap value as the inventory value of some goods it was no longer producing. The write-down was based on the judgment of company officers that the goods were "excess," that is, that the inventory held on hand was greater than reasonably foreseeable future demand. The write-down was taken even though Thor continued to sell these goods at its original price.

The Supreme Court concluded that, although the taxpayer's method was consistent with the best accounting practice, it did not clearly reflect income and was "plainly inconsistent with the applicable regulations." In so doing, the Court affirmed the prior decisions of the Tax Court and the Court of Appeals for the Seventh Circuit. The Supreme Court did not in any way change the law. It merely affirmed the longstanding inventory regulations and the Commissioner's authority to apply them.

To aid this Subcommittee in considering possible taxpayer suggestions involving the tax accounting rules, there are two additional points made by the Supreme Court in its opinion that I would like to bring to your attention. The first concerns the need for an objective standard in determining inventory valuations, and the second concerns the relationship between tax accounting and generally accepted accounting principles used for financial reporting (commonly referred to as "GAAP").

The use of the lower of cost or market method of inventory valuation for tax purposes is a limited exception to the principle that taxable income is based on realized gains and losses. The lower of cost or market method is based on the rule of conservatism, a primary postulate of GAAP. However, while the lower of cost or market method has long been allowed as an acceptable accounting practice for tax purposes, use of the method must be strictly construed and be based on easily audited objective evidence, not subjective judgment. The regulations therefore provide that normal inventory can be valued at market (replacement cost), if lower than actual cost, and can only be written below replacement cost if actually scrapped (a realization event) or offered for sale at a lower price, both objective standards. For our tax system to be administrable, the tax paid by a taxpayer must be based on evidence that is objective and verifiable. This is especially the case in

areas where the potential for abuse is great. The Supreme Court recognized the need for the regulations to require objective evidence. The Court observed:

> "If a taxpayer could write down its inventories on the basis of management's subjective estimate of the goods' ultimate salability, the taxpayer would be able, as the Tax Court observed [at p. 170], 'to determine how much tax it wanted to pay for a given year'."

and

> "In light of the well-known potential for tax avoidance that is inherent in inventory accounting, the Commissioner in his discretion may insist on a high evidentiary standard before allowing writedowns of inventory to 'market'." [footnote omitted]

The second point involves the relationship between tax accounting and financial accounting standard. The taxpayer in Thor argued, and the Commissioner agreed, that Thor's write-down of "excess" inventory was in compliance with, and in fact was required by, generally accepted accounting principles. Thor contended that this was in accordance with the best accounting practice requirement of section 471 and created a presumption that it is therefore a valid method of accounting for tax purposes. Aside from holding that neither the Code nor Regulations embody a presumption of conformity, the Supreme Court stated that the existence of any such principle is unsupportable in light of the differing objectives of tax and financial accounting. In the following excerpt from Justice Blackmun's opinion the Court explains why conformity is unsupportable:

> "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.' In view of the Treasury's markedly

> different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable." [footnotes omitted]

We concur with the Court and reject arguments that an objective of tax accounting standards be that it conform with GAAP.

Background of Rev. Proc. 80-5 and Rev. Rul. 80-60. With the announcement of the Supreme Court's decision in *Thor* on January 16, 1979, the issue of the application of the inventory regulations to "excess" inventory was resolved, or so we thought. The IRS was aware that many taxpayers were valuing "excess" inventory by a method not in accordance with the regulations and were using a method similar to that used by Thor Power Tool Company. Since a fundamental principle of our tax system is that it is a self-assessment system, the IRS believed that once the Supreme Court decision was announced, noncomplying taxpayers would comply with the inventory regulations.

In fact, as a result of the Supreme Court's decision, a number of taxpayers did change to the proper method. However, in late July, 1979, over six months after the Supreme Court's decision, the IRS learned that a number of tax practitioners were taking the position that taxpayers did not have to voluntarily change to the proper method, but instead could wait until the IRS discovered upon audit that the taxpayer's method was in violation of the regulations and the Supreme Court decision.

This position was based on a technical point involving changes in methods of accounting. Section 446(e) of the Internal Revenue Code provides that a taxpayer may not change its method of accounting without receiving the consent of the Commissioner. Therefore, the position of these practitioners was that, since section 446(e) requires consent, and since consent had not been requested and therefore not received, taxpayers should continue using the old method of accounting.

Section 446(e) was enacted in 1954 to codify a longstanding Treasury regulation, the purpose of which was to allow the IRS to monitor the accounting method area so as to prevent taxpayers from adopting improper methods of accounting and to ensure that proper adjustments are made to

avoid duplications or omissions of items of income or deduction. We concur that consent of the Commissioner is needed before a change of accounting method can be made. However, it is clear that Congress never intended section 446(e) to be used as a shield by taxpayers to avoid changing from clearly improper methods of accounting. We reject the idea that a taxpayer can continue to use a method of accounting which he knows is improper (and subject to change if audited) and need not voluntarily change to a proper method in accordance with IRS procedures.

As a general rule, the IRS does not issue an announcement that it will follow a decision of the Supreme Court, and initially did not contemplate issuing an announcement with respect to the Supreme Court's decision in Thor. However, after careful consideration, the IRS decided that the most practical way of enforcing the Court's decision was to grant blanket permission for all taxpayers using an improper method of accounting for "excess" inventory to change to the proper method in accordance with the regulations.*

Rev. Proc. 80-5 and Rev. Rul. 80-60. To implement the Supreme Court's decision, the IRS issued, on February 8, 1980, Rev. Proc. 80-5 which grants to all affected taxpayers the Commissioner's consent required by Sec. 446(e) to change to the proper method of accounting for "excess" inventory. Such consent was granted for the taxpayer's first taxable year ending after December 24, 1979, thus applying for 1979 to taxpayers who use the calendar year. Rev. Rul. 80-60, issued with Rev. Proc. 80-5, reviews the legislative history of Section 446(e) and holds that since consent has been granted, taxpayers in violation of the Supreme Court's decision in Thor must comply with the regulations and change their method of accounting on their 1979 tax returns. Rev. Proc. 80-5 provides detailed rules as to how the change is to

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*In addition, in 1979 the IRS modified the questions relating to the inventory methods used by corporations. These questions require disclosure of all improper inventory methods. The 1979 corporation income tax forms were released and available in the fall of 1979.

be made and, consistent with current Service policy on voluntary changes of method of accounting, allows taxpayers, in general, to amortize over 10 years the additional taxable income resulting from the change.* Thus, taxpayers can generally pay the increase in tax over 10 years, without interest.

While Rev. Proc. 80-5 was issued on February 8th of this year, the IRS believes that all taxpayers will have had sufficient time to make the requisite computations in order to properly prepare their 1979 income tax returns. To ensure this, Rev. Proc. 80-5 provides that every taxpayer has an additional six months after its return is otherwise due (without regard to extensions) in which to comply with the provisions even if the taxpayer files its 1979 return at an earlier time. In the case of calendar 1979 corporations, this is September 15, 1980, the time when most calendar year corporations file their 1979 return. Informal comments received indicated that this would be sufficient time to comply and to date no one has told the IRS of any procedural problem. The IRS has not been told of a specific situation where an unreasonable return preparation burden has been placed on a taxpayer because of the date the Rev. Proc. was issued. In fact, to date the IRS has received forms making the required change in accounting method from over 500 taxpayers.** We believe this is a large number considering that most corporations do not file their income tax return until September 15, 1980 and that every taxpayer has until

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* The spread period is less than 10 years if the taxpayer has used the improper method for less than 10 years or a substantial portion of the benefits of the old method was obtained in the preceding three years. The Rev. Proc. also allows taxpayers to elect to treat the change as being "involuntary" and thus reduce the adjustment to the extent it is attributable to years prior to 1954 (although the remaining adjustment cannot be amortized over 10 years), if doing so would be more beneficial.

** On 68% of the forms filed the total adjustment was less than $100,000, or less than $10,000 a year.

that date to comply with Rev. Proc. 80-5. We believe that most affected taxpayers recognize that they have been using an improper method of accounting and are willing to comply with the regulations and the Supreme Court.

After Rev. Proc. 80-5 was issued, certain problem situations came to the attention of the IRS, *e.g.*, relating to subchapter S corporations and the penalty for underpayment of estimated tax. Therefore on April 8th, the IRS made eight amendments to Rev. Proc. 80-5 to ameliorate these problems and lessen some administrative burdens. In summary, we believe that Rev. Proc. 80-5 and Rev. Rul. 80-60 represent a fair and equitable action by the IRS in implementing a Supreme Court decision and longstanding regulations.

S. 2805. The supporters of S. 2805 contend that since the IRS issued Rev. Proc. 80-5 and Rev. Rul. 80-60 after 1979, it is unfairly retroactive and should not apply to 1979. We agree that changes in the tax law should rarely be retroactive, but the regulation as to proper methods of accounting for inventory are the same in 1979 as they have been for over 50 years. Rev. Proc. 80-5 and Rev. Rul. 80-60 do not change any substantive law, but merely provide the procedure for complying with the *Thor* decision.

In fact, Rev. Proc. 80-5 provides a benefit to all taxpayers to which it applies. We reject the notion that whenever the Supreme Court upholds a longstanding Treasury regulation, such regulation should be applied on a prospective basis only. Thus, the IRS could require compliance with the *Thor* decision as part of a return examination for *any past* open year. When taxpayers claim that Rev. Proc. 80-5 is retroactive they are asserting that the IRS does not have sufficient agents to find them all and that they have a right to keep their identity a secret.

A second argument made by supporters of S. 2805 is that they were unaware of the inventory accounting dispute involved in *Thor* until the IRS issued Rev. Proc. 80-5 and Rev. Rul. 80-60 in February. We are doubtful. The *Thor* case was carefully watched by the business community since the Tax Court decision in 1975 upholding the Commissioner's position. Both the Tax Court decision, as well as its affirmation by the Court of Appeals, were widely reported and commented on. In addition, the Supreme Court's decision in *January, 1979* was reported in the national press. We also understand that the organization that is one of the prime lobbyists for S. 2805 itself reported the Supreme Court decision and its effects to its members in early 1979.

A third argument made by supporters of S. 2805 is that, by issuing Rev. Proc. 80-5 and Rev. Rul. 80-60 in February, 1980 applicable to 1979, taxpayers did not have an

opportunity to scrap or offer for sale their "excess" inventory before the end of 1979. Very simply, that is not true. Every taxpayer had at any time the opportunity to scrap or offer for sale their "excess" inventory, and, in accordance with the longstanding regulations, take an inventory write-down. Rev. Proc. 80-5 and Rev. Rul. 80-60 did not change the law applicable to 1979 or any earlier year. For over 50 years the regulations have provided that normal inventory (which includes "excess" inventory) could not be written down below replacement cost unless it was scrapped or offered for sale. Any doubts were put to rest on Janaury 16, 1979 with the announcement of the Supreme Court's decision in Thor. Even if, before the Supreme Court's decision, a taxpayer believed that the Commissioner's interpretation of the regulations was incorrect, it was on notice more than 11 months before the end of 1979 that it now must proceed on the basis that an inventory write-down for "excess" inventory can only be taken if the goods are scrapped or offered for sale. Thus, all taxpayers had over 11 months to engage in any planning opportunities to legitimately maximize any benefits to be derived under proper methods of accounting. Could any taxpayer or tax practitioner really have thought that the IRS would not follow the Court's decision?

In fact, the IRS can examine the return of any prior taxable year that is still open for examination and assess additional tax on the basis that the taxpayer's method of accounting for "excess" inventory is not in accordance with the regulations and the Supreme Court decision. In that situation, and many such assessments have been proposed, if a taxpayer had not scrapped or offered the goods for sale in the year under examination, no deduction would be allowable. Thus, a taxpayer is in no worse position due to the issuance of Rev. Proc. 80-5 than if its returns for prior years were examined. In fact, in many cases taxpayers are better off with the issuance of Rev. Proc. 80-5 since the year of change is a later year (thereby resulting in a lower amount of interest) and, because a 10 year spread forward from 1979 is allowed, 90% of the increase in tax is not currently due.

Further, taxpayers can still scrap, or offer for sale, their "excess" inventory during 1980 and receive the tax benefits of a realized loss. But, it has been answered, this would be a year later. That argument is more form than substance since, while the full loss would be recognized in 1980, only one-tenth of the income adjustment would be recognized in 1979. We do not believe that these taxpayers suffer any significant detriment for losing the benefits of deferral of one-tenth of the adjustment for one year, especially when it is weighed against the benefits of

deferral these taxpayers have received during all of the years that the improper method was used.*

We also have serious doubts as to whether taxpayers advancing this argument would have actually scrapped the inventory before the end of 1979. Whether to scrap would still be a decision based in large part on nontax, business considerations.

Conclusion. We do not believe that any delay in effect of Rev. Proc. 80-5 and Rev. Rul. 80-60 is warranted and therefore strongly oppose enactment of S. 2805. Rev. Proc. 80-5 was not a retroactive change in the tax law. We believe that most taxpayers who are using an improper method of accounting for "excess" inventory recognize that fact and are and have been willing to comply with the regulations and the Supreme Court. This is evidenced by the high number of taxpayers that have complied so far. The IRS has reacted in a responsible manner to the position of some tax practitioners regarding required compliance with the decision of the Supreme Court. I urge you to reject S. 2805.

S. 2904: Manufacturer's Excise Tax on Tires

S. 2904 would reduce the excise tax on new tires by 2.5% from 10 cents to 9.75 cents per pound on tires used on highway vehicles and from 5 cents to 4.875 cents per pound on tires used on nonhighway vehicles. The rate reduction is coupled with the disallowance of any refunds (except during a two-year transition period) in connection with adjustments made in the price of a tire pursuant to a warranty.

Treasury supports S. 2904.

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* Supporters of S. 2805 have also argued that it is unfair that Rev. Proc. 80-5 was issued 39 days after the end of 1979, thereby precluding the use of the special 30-day rule of Section 1.471-2(c) of the regulations. That rule allows the writedown of "subnormal" or "obsolete" type goods if they are actually offered for sale within 30 days after the end of the year. However, "excess" inventory is not subnormal and the 30-day provision of the regulations is not applicable to situations covered by Rev. Proc. 80-5. Since Rev. Proc. 80-5 and Rev. Rul. 80-60 do not apply to subnormal or obsolete-type inventory, this argument is not relevant.

I believe that an explanation of the background of this issue would be useful to the Subcommittee. On November 1, 1976, the IRS issued a ruling (Rev. Rul. 76-423) which set forth the method for computing the credit or refund of excise tax allowable to a tire manufacturer that makes a price adjustment to a dealer on account of a defective tire. The ruling held that the refund should be computed on the basis of the price adjustment between the manufacturer and the dealer (even though the tax adjustment was fully passed on to the consumer). In so holding, the ruling overturned a method which the industry had followed for over 40 years, which computed the refund on the basis of the price adjustment between the dealer and consumer. While theoretically the IRS' position in the 1976 ruling was correct, in light of the IRS' longstanding tacit acceptance of their previous method of calculation, there were strong equitable grounds for the industry's position. Moreover, the industry argued that it would have been able to restructure its distribution system with retail dealers to retain the same pre-1976 ruling tax results, but at considerable cost.

In view of these considerations, the Treasury decided not to oppose legislation which the industry sought to have enacted to codify their longstanding method of computing refunds. We also twice agreed to delay the effective date of Rev. Rul. 76-423, first to October 1, 1977 and then to April 1, 1978, in order to allow time for the industry to attempt to obtain legislative relief.

However, in supporting such legislation (which was extraordinarily complex and yet apparently not a full solution for some aspects of the industry), Treasury took the position both in discussions with the industry and in testimony before Congress, that a more equitable and simple solution to the problem would be to reduce the rate and not allow any warranty adjustments. Due to the press of business in both 1977 and 1978, Congress failed to enact any legislation.

Treasury continues to believe that a rate reduction and elimination of warranty adjustments, such as are provided in this bill, is the most sensible approach to the problem.

Accordingly, Treasury supports S. 2904 because it would achieve ease of administration for both the government and the industry on an essentially revenue neutral basis.

S. 2967: ESTATE AND GIFT TAXES

I shall now discuss S. 2967, relating to estate and gift taxes.

Before addressing the specifics of the bill, I should like to make a few general comments. A comprehensive consideration of the federal transfer (gift, estate and generation-skipping) taxes should start with an identification of a "normative" transfer tax structure. Speaking broadly, the structural questions to be addressed include the definition of the tax base, the determination of the appropriate taxable unit, the integration of taxation of lifetime and deathtime transfers, the periodicity of the imposition of the tax and the identification and resolution of anticipated administrative difficulties. A separate, but equally important, issue is the rate structure to be applied to transfers which the normative structure defines as taxable. This issue encompasses the determination of the point at which the tax commences (the exemption level) as well as the progressivity of the rates applied to taxable transfers.

The utility of this analysis has already been recognized by the Congress in the income tax area where, pursuant to the Budget Act of 1974, a "normative" income tax structure has been identified. The departures from that structural norm, which are generally intended to achieve a specified social, economic or regulatory goal, are variously defined as "tax expenditures," "tax incentives," or "tax subsidies." Tax expenditures are quantified and published annually.

The quantification of these departures from a structural norm serve to identify the amount of indirect government spending through the tax system to achieve a desired goal. Once the amount of spending is identified, the cost of a specific provision can then be compared with the benefits achieved and a rational determination of the operation of the subsidy can be made.

To date, there has been no such analysis of the transfer tax system. Yet a comprehensive analysis of that system demands that a process similar to that applied in the income tax area be undertaken here as well. Indeed, this is the only way provisions such as section 2032A, regarding the special valuation of farm and small business property, can be analyzed effectively.

The question of the impact of the transfer tax upon various sectors of the economy such as small business or family farms raises different issues. Assuming we could agree on the definition of a "small" business or "family" farm, we would want to know how existing law affects their continued existence. The Tax Reform Act of 1976 contained a number of estate tax liquidity relief provisions, the effect of which should be understood before more tinkering is done. For example, does the transfer tax requires the forced sale of the small business or farm to pay estate tax? As a factual matter, how many farms or closely-held businesses have had to be sold to pay estate taxes, and with what overall economic consequence?

These issues are not being ignored by Treasury. We have begun to examine some of the quantitative aspects of the incidence of the present transfer tax. This undertaking has demonstrated dramatically the lack of readily accessible, accurate data.

I would like now to turn to the bill before the Subcommittee today. This bill would enact piecemeal changes to some of the most basic components of the transfer tax. While some of these changes may be appropriate in whole or in part in some context, we are not in favor of making such changes until their structural and policy ramifications have been fully examined in the context of an overall review of transfer taxes.

Section 2 -- Increased Unified Credit

Section 2 would increase the unified credit from $47,000 to $155,800, phasing in the increase over four years to 1985. This increase in the unified credit would be accompanied by a phased increase in the filing threshhold from the present amount of $175,000 to $500,000 in 1985.

The size of the unified credit is, at bottom, a political question. The extent to which it is appropriate to subject transfers of wealth to tax involves a determination of the role the transfer tax plays, or ought to play, in the distribution of the overall tax burden among the citizens of this country.

When looked at in this light there is no magic to any particular number. The Congress is obviously free to reexamine the issue as it deems necessary. However, in the context of this examination we believe it is appropriate to

point out that the transfer tax makes a significant contribution to the overall progressivity of the tax system. The $5 to $6 billion of annual receipts from the transfer tax is collected principally from those who were taxed on their income at a rate in excess of the average effective income tax rate and is equal to about one-third of the income tax collected above the average effective rate. If this overall rate of progressivity reflects our social judgment as to what is appropriate, changes in the exemption level would require other adjustments to retain an acceptable rate of progressivity.

Indeed, the overall rate of progressivity of the tax system has already been altered from that which Congress thought appropriate in 1976. Carryover basis was the quid pro quo for the substantial estate relief enacted at that time. Moreover, carryover basis preserved, in general, the pre-existing progressivity of the system. Little attention was paid to this fact in the "debate" over the repeal of carryover basis. However, the fact remains that the combination of step-up in basis at death, with its attendant forgiveness of the income tax on unrealized appreciation in property held at death, and a smaller transfer tax base had reduced the progressivity of the tax system. Further erosion of the transfer tax base through a larger unified credit would do likewise. Before this is done, the consequences should be fully explored.

We have not, as yet, been able to complete an analysis of the effects of the proposal on overall progressivity. However, we can offer the following. At an exemption level of $155,800 transfer tax receipts would drop $4 billion annually when fully implemented in 1986. Only approximately 1.4 percent of decedents' estates would have to file estate tax returns annually and only 4/10 of one percent of all estates would be taxable. And this is not the whole picture.

The fact that there is a difference between the number of decedents whose estates are required to file estate tax returns and those whose estates are taxable illustrates why it is also necessary to analyze the exemption level in conjunction with other provisions of the estate and gift tax. Under present law, if a decedent were to die with an estate of $425,000 left to his spouse, no tax would result. If the estate contained a farm or other trade or business real property which qualified for special use valuation he could, after a maximum $500,000 reduction in value, leave property worth up to $925,000 to his spouse tax free. Through appropriate lifetime gifts to a spouse, plus use of the

estate tax marital deduction, a decedent may transfer $601,250 to a spouse tax free. These examples make it clear that the present unified credit, together with other provisions in the Code, enable decedents to transfer substantial amounts of wealth, free of tax. Consequently, we are not convinced any change in the recently enacted exemption level is appropriate.

Section 3 - Unlimited Marital Deduction

Section 3 of the bill would revise the present estate and gift tax to permit spouses to transfer property to each other without incurring either gift or estate tax. This proposal is known as an unlimited marital deduction.

Adoption of an unlimited marital deduction would fundamentally change the conceptual structure of the transfer tax. The marital unit would replace the individual as the basic taxable unit.

The marital deduction was enacted in 1948 to redress an imbalance between community property and common law states. In community property states, only one-half the community property was included in a decedent's estate. In common law states, estate tax inclusion generally was determined by legal title. To illustrate, if the sole asset of a husband and wife consisted of property worth $1,000,000 which had been acquired through the earnings of the husband, $500,000 would be included in his estate if he were a resident of a community property state, while $1,000,000 would be included if he resided in a common law state. Congress chose to redress this imbalance by allowing the common law state decedent a deduction ("the marital deduction") of up to 50 percent of the adjusted gross estate for property passing to a surviving spouse.

When viewed in this historical context, the marital deduction does not represent an abandonment of the principle that the individual is the basic taxable unit for purposes of the transfer tax. Rather, it is more appropriately viewed as a response to disparities created by local property law. The 1976 expansion of the marital deduction, together with 1976 and 1978 changes in the tax treatment of property jointly owned by spouses, however, does indicate some movement away from the community property model for the marital deduction.

In 1969 the Treasury published recommendations which would have substantially revised the transfer tax system. The Treasury proposals were the result of a comprehensive review of the federal transfer tax system. An unlimited marital deduction was one of those proposals. The Treasury also recommended substantive unification of the estate and gift tax (rather than merely unifying the rate structure as was done in 1976) including an expansion of the transfer tax base to include the gift tax paid on lifetime transfers as part of the property transferred. Unification would have been accompanied by simplification and rationalization of the treatment of transfers with various retained interests. Other proposed changes involved the treatment of employee benefits, insurance and the taxation of unrealized appreciation at death.

It was in this overall context that proposals to change the marital deduction were made. Nor was the unlimited marital deduction the only aspect of interspousal transfers studied. The Treasury also recommended that the definition of interests qualifying for the marital deduction be liberalized. Furthermore, an election to subject otherwise qualifying property to tax was provided in order to accommodate the varying interests of surviving spouses; some desire estate tax deferral while others seek minimization of the overall estate tax burden.

Thus, while Treasury is not necessarily opposed to a change in the definition of the transfer tax unit, we do not believe that this bill addresses the issue adequately. We are, therefore, opposed simply to providing an unlimited marital deduction.

Section 4 - Gift Tax Annual Exclusion

The size of the gift tax annual exclusion raises a different type of structural question. The original reason for the annual exclusion was administrative convenience; to avoid the need to account for small gifts. The exclusion was not an incentive to encourage individuals to transfer property by gift. Thus, arguments that it is appropriate to raise the exclusion level to adjust for the inflation that has occurred since the exemption level was set at $3,000 miss the point. The appropriate inquiry is not how much an individual should be allowed to give away annually tax free. Rather, it is to determine the point at which it is reasonable to expect him to account for gifts.

An exclusion of $6,000 per year could result in massive transfer tax avoidance. A husband and wife with two married children could make annual transfer of $48,000 without paying any tax. This would make large inroads on the transfer tax base. Viewed in this way, the $3,000 figure does not appear too small.

An examination of the appropriate exclusion level does, however, raise other questions that should be considered. A variety of expenditures typically made by parents for the benefit of their children such as tuition payments for private school, college or graduate school do not necessarily fall within the legal definition of support. Such payments, are, under present law, treated as gifts. This in turn places pressure on the $3,000 exclusion. Thus, it might be appropriate in this context to explore further the possibility of a uniform and expanded federal tax law definition of support.

Section 5 - Special Use Valuation

Where a "family farm" constitutes a large part of a decedent's estate, the estate may now take advantage of a special valuation method intended to determine the value of the land for use in farming (special use valuation) even if someone would pay more to use the land for non-farm purposes. Section 5 of S. 2967 would make substantial changes in the current provisions relating to special use valuation. I shall summarize each of the areas of change and indicate the Treasury Department's position on each before proceeding to a detailed discussion.

1. Section 5 would substantially alter the requirement of material participation by members of a family both before and after the decedent's death. The Treasury Department is opposed to this proposal.

2. Section 5 of the bill would eliminate the requirement that land continue in a qualified use for 15 years and would limit the requirement for qualified use to 10 years. The Treasury Department is opposed to this proposal.

3. Current law provides that special use valuation may not reduce the fair market value of the property by more than $500,000. Section 5 of the bill would eliminate this restriction. The Treasury Department is opposed to this proposal.

4. Current law imposes a recapture tax to take back the estate tax benefits of the special use valuation if the qualified property is disposed of or the use is changed after the decedent's death. The proposal in section 5 would allow a transfer to a non-family member of the qualified property if the family members receive in exchange like-kind property which is also used in any qualified use. The Treasury Department is opposed to this proposal.

5. Under current law, no recapture of the special use tax applies if an election is made upon an involuntary conversion of the property so long as the property is replaced by qualified use property. Section 5 of the bill would eliminate the need to make an election for this provision to apply. The Treasury Department is opposed to this proposal.

6. Section 5 would amend the special use valuation formula to permit the use of net crop share rentals. The Treasury Department is opposed to this proposal. However, if the special use formula were amended as described below, the Treasury Department would not oppose the revision to the formula contained in section 5 of the bill.

7. Finally, section 5 would amend the basis provisions of the Code to provide a "step up" in basis for section 2032A property if estate tax benefits are recaptured due to a disposition of the property or cessation of qualified use. The Treasury Department is opposed to this proposal.

Policy

At the outset of this statement I indicated that section 2032A was a provision that would plainly be considered a "tax expenditure" if that analytic framework were applied to the estate tax. Therefore, it is particularly appropriate to consider these proposals in the context of the public policy rationale for this section and inquire whether, in fact, those objectives are furthered by either the existence of section 2032A or the proposed amendments.

Section 2032A was added to the Code in 1976 as part of a major restructuring of the estate and gift tax provisions. The legislative history of this section indicates that it was intended to provide an alternative valuation method for estates consisting in large part of family farms or other closely-held business when there was another use for the

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property.* The 1976 change was justified on the ground that valuation based upon another use forced the sale of farmland to pay estate tax and thus was a principal factor in the decline in the number of "family farms". However, the statute provides that the special valuation is available for any farm or closely-held business property that meets statutory threshold requirements; it is not necessary for the property to have any other potential use in order to qualify for the benefits. This literal reading of the statute is reflected in the final Treasury regulations issued under section 2032A.**

The economic effects of special use valuation probably will not be known for several years, but analyses already made suggest that section 2032A may have unintended and counterproductive results. In a recent study,*** Professor Neil E. Harl**** concludes that the estate tax shelter provided by section 2032A would encourage older farmers toward greater investment in land and less investment in nonland assets and that they would be able to outbid younger farmers for a particular tract of land. Thus, it is expected that additional capital will flow into farmland, driving up the price, until investors are once again indifferent between investing in farmland with the benefits of use valuation and investing in other assets at fair market value. Therefore, section 2032A has the effect of raising the price of farmland and thereby creating additional entry barriers for farming to younger individuals.

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* S. Rep. No. 94-1236, 94th Cong., 2d Sess. 610 (1976).

** 45 Fed. Reg. 50736 (July 31, 1980).

*** "Experiences and Problems With 'Use' Valuation of Land," presented at a meeting of the Commissioner's Advisory Group, Internal Revenue Service, Washington, D.C., June 9-10, 1980. For additional comment on the effects of section 2032A, see Woods and Sisson, "The Tax Reform Act of 1976 and U.S. Agriculture," Tax Notes, August 29, 1977, page 3.

**** Charles F. Curtiss Distinguished Professor of Economics at Iowa State University.

Professor Harl also questions the premise of section 2032A, namely, the preservation of the family farm. He indicates that "traditionally" most farm and ranch businesses have begun and ended within one generation. "Very few farm and ranch businesses have continued as a going economic entity into the next generation." Therefore, to the extent that continuation is encouraged by section 2032A, and given the increasing benefits which flow to larger and larger estates, he concludes that a long-range effect on the structure of agriculture may be anticipated "with a hastening in the trend toward fewer and larger farm and ranch businesses."

The broad availability of section 2032A valuation and the anticipated consequences of its benefits suggest that proposals for change in this area must be closely examined. Piecemeal changes, although superficially attractive in some fact situations, may have deleterious and unintended long-range effects on the agricultural economy. For example, one of the proposals in S. 2967 would substitute an "active management" test for the current "material participation" standard with respect to the owners of woodlands. If this test were adopted, then a non-farmer who inherited an orchard would be encouraged to purchase, at a premium, other woodlands that would qualify for special use valuation. This would artificially increase the price of land without encouraging the continuation of a "family" business and would provide a higher entry barrier for individuals who want to start family farms.

With this background and context for analysis, I will now address each of the specific proposals in section 5 of S. 2967.

Material Participation

The special use valuation provisions require "material participation" in the operation of the farm both before and after the decedent's death. The material participation requirement may be satisfied both before and after death by the personal involvement of members of the decedent's family in the operation of the farm.

Section 5 would substantially alter the material participation requirements of present law. Two principal changes are noted here. First, disabled individuals and those receiving Social Security "old age" benefits would not be required to participate in the management of the farm. Second, the bill would permit "active management" rather than

material participation to be the test for qualification under the statute for woodlands (and for certain recipients of the property). "Active management" is defined as "making management decisions" as distinguished from "daily operating decisions."

We believe the material participation requirement is essential in targeting the special use benefits to family farms. Material participation does not require active management by the decedent alone; the requirement is satisfied if a member of the decedent's family personally manages or is personally involved in the management of the farm before the decedent's death. The post-death participation requirement is satisfied if any qualified heir of the decedent actively is engaged in the management of the property. For this purpose, the term "member of the family" is given a wide meaning and includes the decedent's ancestor or lineal descendants, the lineal descendant of a grandparent of the decedent, the spouse of the decedent, or the spouse of any such descendant. For example, this could include the husband of a first cousin of the decedent. The term "qualified heir" is defined to include any member of the decedent's family who acquires qualified property from the decedent. Thus, the first change proposed by this provision is unnecessary; an estate may qualify for special valuation so long as a member of the family participates in the family farm.

Reducing and altering the material participation requirement would increase the opportunity for abuse and permit the application of special use valuation in inappropriate circumstances. It would be possible for a wealthy individual who has no interest in farming other than as an estate tax avoidance device to acquire a substantial parcel of woodland in anticipation of death. Thereafter, so long as the woodland was held in the family and, for example, leased under an "active management" agreement, the benefits of special use valuation would be available even though the farm could not in any sense be referred to as an active family farm. This transforms family farm estate tax relief into a statutory estate tax shelter for the wealthy.

One of the reasons cited for altering the material participation requirement is the alleged failure of regulations to define material participation properly and in all conceivable situations. Proposed regulations defining the requirements for material participation were published in 1978. The purpose of issuing regulations in proposed form is to receive comments and consider issues raised by the public

before preparing binding, final regulations. Treasury and the Internal Revenue Service worked for some time to incorporate the comments received on these proposed regulations. Final regulations were published on July 31, 1980. We believe most of the issues raised by commentators in connection with the proposed regulations are resolved in the final regulations. For example, the proposed regulations did not address the issue of how material participation would be determined where the farmland was timberland. The final regulations provide specific guidance with respect to this matter. Further, other commentators criticized the specific safe harbor tests for material participation. We believe the final regulations reflect more flexible and useful standards in this regard.

I would like to point out again that the concept of material participation does not, as some have suggested, require an infirm widow to work in the fields. Physical work is not required to satisfy the material participation requirement. Rather, in appropriate cases active decision-making in the area of production or management is sufficient. In addition, as noted above, the material participation requirement may be satisfifed by the efforts of one or more family members of the decedent before the decedent's death. We believe this is consistent with the concept of family farming, and that a lesser degree of involvent with farm operations is not.

Recapture

In 1976, Congress recognized that it would be a windfall to the beneficiaries of an estate to allow real property used for farming to be valued at its farm use unless the beneficiaries continued to use the property for farming, at least for a reasonable period of time after the decedent's death. Congress also recognized that it would be inequitable to remove non-farm use value from the estate tax base if the heirs of a decedent realized the higher value by selling the property within a short time after the decedent's death. For those reasons, current law provides for recapture of the estate tax benefit attributable to special use valuation where the land is prematurely sold or converted to a non-qualified use.

The Code specifically provides that if, within 15 years after the death of the decedent (but before the death of the qualified heir who receives the property), the property is disposed of to non-family members or ceases to be used for farming purposes, all or a portion of the Federal estate tax

benefits obtained by virtue of the reduced valuation are to be recaptured. In general, if a recapture event occurs within 10 years of the decedent's death, the recapture tax is imposed in full. If the recapture event occurs more than 10 years but less than 15 years after the decedent's death, but prior to the death of the qualified heir, the amount subject to recapture is phased out on a ratable monthly basis.

Section 5 of S. 2967 would terminate recapture at the end of 10 years after the decedent's death. The Treasury Department is opposed to this proposal. The goal of protecting the family farm requires an extensive period of continuing qualified use and ownership by family members after the decedent's death. Moreover, the substantial estate tax savings made available to the family farm under the special use valuation provisions can be justified only if these conditions are met.

<u>$500,000 Limitation</u>

The special use valuation provisions allow the executor of an estate to elect to value real property in the estate which is devoted to farming on the basis of that property's value as a farm without regard to its non-farm value. However, this special use valuation cannot reduce the decedent's gross estate by more than $500,000.

Section 5 of S. 2967 would eliminate this $500,000 restriction.

The Treasury Department is opposed to elimination of the $500,000 restriction for two reasons. First, special use valuation was added to the Code in 1976 to allow family farms to be valued <u>on the basis of farming use</u>. In most cases, if properly appraised, the difference in value between farm and commercial use should not be substantial.

However, as discussed below in connection with the proposed amendments to the special use formula, experience to date indicates that the special use valuation provisions are providing values up to 80 percent below the fair market value of the farm as determined by the executor of the estate. If the $500,000 limitation were removed, this discount from the fair market value would be even greater. In a time of fiscal restraint, it is difficult to justify eliminating a restriction on an already generous provision.

Second, elimination also would seem contrary to the original intent of the limitation, which was apparently to target the benefits of special use valuation to "medium and small" estates.

Any exclusion results in greater benefits to larger estates. Complete elimination of the $500,000 restriction would exacerbate this situation and, given the deficiencies in the special use valuation formula, would amount to a potentially unlimited deduction.

Tax-Free Exchanges

The current special use valuation provisions provide for recapture of the estate tax benefits if the qualified property is disposed of to non-family members in any fashion (except for involuntary conversions discussed below). Section 5 of S. 2967 would eliminate the recapture tax where qualified property is exchanged for like-kind property to be used for the same use as the previously held property or <u>any other</u> type of farm use. Section 5 of S. 2967 would also reduce the recapture tax in situations where property was disposed of in a taxable transaction which involved in part an exchange of similar property.

The Treasury Department is opposed to this proposal on two grounds. First, a like-kind exchange is a voluntary act. The voluntary shift of a farming enterprise does not need special protection. Use of the section 1031 "like-kind" standard and the specific references to any other use in the proposal would allow substantial shifts in the type of use without recapture. For example, this proposal would allow a family to exchange land used for growing crops for woodlands which could then be leased under the "active management" test also proposed by the bill. Second, this proposal would add substantial complexity to an already complex provision. For example, issues would certainly arise as to whether the property received in exchange was like-kind property. Resolution of these issues would require both the Internal Revenue Service and taxpayers to expend resources that could otherwise be devoted to more productive use.

Involuntary Conversions

The special use valuation provision allows a taxpayer to replace involuntarily converted qualified use property with similar property and thereby to avoid the recapture tax. For this purpose, an involuntary conversion results from destruction, in whole or in part, theft, seizure or requisition or condemnation of the property.

Section 5 of S. 2967 would eliminate the requirement that the qualified heir elect to have the involuntary conversion exception apply. The Treasury Department is opposed to this proposal. The election provides the mechanism by which the Internal Revenue Service can monitor whether qualified reinvestments occur. Far from being a trap for the unwary, the election is necessary to assure the proper administration of the provision.

Crop Share Rentals

The special use valuation provisions include two methods for valuing family farms. The first method involves the use of a mathematical formula, and is intended to minimize subjectivity in farm valuation. The second method, available to all property eligible for special use valuation (i.e., farms and real estate used in certain closely-held businesses), involves the application of a list of commonly accepted appraisal factors to the property, including the capitalization of income from the property.

Section 5 of S. 2967 would amend the formula method to permit net crop share rentals to be taken into account.

An example may help to illustrate the change in the law which was made by the special use valuation provision, the issue addressed by this portion of section 5 of S. 2967, and the problem we have with the current law.

Farmer A actively participates in the day to day operations of a farm he owns about 20 miles outside of Washington, D.C. A has received offers of $1,000 an acre for his land from individuals in the vicinity who want to begin farming. However, A knows that other farmers in the area have sold their land for $1,500 per acre to speculators who are interested in commercial development.

If Farmer A had died before January 1, 1977, the date the special use valuation provisions became effective, then the Internal Revenue Service could have argued that his farm land should be valued for estate tax purposes at $1,500 per acre because that was the price that developers were willing to pay.

Section 2032A was added to the Code to prevent the $1,500 valuation of Farmer A's land. To illustrate, if under the application of commonly accepted appraisal factors, the value of A's farm land, used as farm land, is $1,000 per acre

(which is also the amount others who would have used the land in farming were willing to pay A for his land), section 2032A enables the executors of Farmer A's estate to reduce the estate tax valuation. However, to do so the executors are required to engage in a factual determination involving some subjective factors. The formula method of valuation in section 2032A avoids this subjectivity.

The formula starts with the average annual gross cash rental for comparable land and subtracts the average state and local real estate taxes on comparable land. The result is then divided by the average annual effective interest rate for all new Federal Land Bank loans and the result is the value of the farm for estate tax purposes.

Two problems arise under the formula, one which section 5 of S. 2967 seeks to remedy and another which concerns the Treasury.

The problem addressed by the bill is the limitation of the formula to areas where there are gross cash rentals for comparable land. In many areas of the country, farm land is rented on an "in-kind" or crop share basis, rather than for cash. In these areas, the mathematical formula is not available. In other words, if land comparable to A's was not rented for cash, A's estate would not be entitled to use the formula. While the land may nonetheless be valued under section 2032A by using the commonly accepted appraisal approach, this method is not as simple or as objective as the formula.

The formula is designed to produce a farm use value roughly equivalent to that which would be derived by appraisal. However, as currently stated, the formula significantly understates farm use value. This occurs because the denominator of the fraction, the effective interest rate charged by the Federal Land Bank, is too high. For example, assume a realistic capitalization rate would be applied under the appraisal factor method to determine that Farmer A's land was worth $1,000 per acre as farm land. However, the current mathematical formula would give a value to the land of less than $500 per acre, a more than 50 percent reduction from the appraised value of the land for farming. Thus, the formula reduces Farmer A's estate taxes far below the amount intended by section 2032A.

This example is neither unusual nor exaggerated. Filings with the Internal Revenue Service show that farms having no potential use other than farming are nonetheless

being valued at a substantial discount under the formula. Of 54 Internal Revenue Service offices reporting values determined by estate executors (not by the IRS) in a nationwide survey, 20 offices reported average values below 40 percent of the fair market value of the land as a farm. The remaining offices also reported substantial discounts. In some areas, the executor's own calculation of the discount from the value of the land as farm land has been as high as 80 percent. We believe that even these figures do not fully reflect the effect of this discount since in most examined cases, fair market value as reported by the executor has been found to be lower than the finally agreed value. Indeed, section 2032A was estimated to cost $14 million per year when enacted. However, current figures show that unless this problem is corrected, the annual cost may be ten times that amount.

We recognize that the goals of simplicity and objectivity will be more readily achieved if the simple, mathematical formula approach is expanded. Although the calculation of the value of net crop share rentals will introduce an element of subjectivity into the formula, we are willing to accept this approach if the formula is revised so that it will reflect more clearly the value of the farm as farm land.

We believe the undervaluation problem in the current formula can be remedied by providing a more realistic capitalization rate. We would propose that the denominator of the formula be changed to equal the greater of four percent or the annual rate of return on equity from farm production. Specifically, the rate of return on equity from farm production would be determined, on a state-by-state basis, by subtracting government payments from net farm income and dividing the result by proprietors' equities. Each of these three figures is readily available from Department of Agriculture publications. The Agriculture Department data would guarantee a fair value based upon the land's use as farm. It would not increase the value to reflect non-farm use or reduce the value by using an unrealistic interest rate. It would not decrease the number of estates eligible to use the formula or take away any of the objectivity or certainty currently available in applying the formula. In other words, this proposal would merely modify the formula so that the valuation of a farm under the formula would reflect more accurately the farm's fair market value as a farm.

If this portion of section 5 were amended to include this change in the interest rate, we would not object to it.

Basis on Recapture

Current law provides that the basis of property received from a decedent is its fair market value on the applicable valuation date. However, where special use valuation is elected, the basis of the property subject to the election is its special use value.

Section 5 would amend this rule to provide that where property is disposed of or ceases to be used for a qualified use and there is a recapture of the estate tax benefits from special use valuation, the basis of this property would be increased to its fair market value. Although not clear from the bill, we assume this value would be determined as of the date of the decedent's death.

The Treasury Department is opposed to this proposal on two grounds. First, the recapture of tax benefits which applies if specially valued property is disposed or ceases its qualified use does not include an interest element on the deferral of the estate tax. If this proposal were adopted, a qualified heir could achieve an interest-free deferral of estate tax on specially valued property.

Second, even if interest were charged on the recaptured estate tax, we do not believe the increase in basis following recapture is justified. If the purpose of section 2032A is to encourage the continuation of family farms and other closely-held businesses, the estate tax provisions should provide incentives to continue in family farming. The provision in current law which provides that the basis of property is its special use value is such an incentive since it will generally discourage the disposition of the property.

Section 6 - Gifts Within Three Years of Death

The proposal to redefine the amount included in the gross estate when a decedent dies within three years of having made a taxable gift would make some sense in the context of a unified transfer tax (rather than simply a unified rate structure). However, its merit is questionable under present law.

Section 7: Election to Waive Unified Credit

Section 7 of the bill makes the use of the unified credit otherwise available against a gift tax elective. The alleged need for an elective unified credit arises from the operation of the statute of limitations on the valuation of gifts. Section 2504 provides that the Service may not redetermine the value of a prior gift if a gift tax has been assessed or paid and the statutory period has expired. Unless the use of the unified credit is elective, no gift tax will be assessed or paid until a donor's taxable gifts exceed $175,000. Thus, it alleged that new valuation uncertainties will exist -- uncertainties that did not arise under prior law where the use of the specific exemption was elective. Moreover, it is alleged that these uncertainties are more significant since the 1976 unification of the gift and estate tax rate structures and the fact that the estate tax now depends upon the amount of prior taxable gifts.

As we interpret the bill, a taxpayer who has made a taxable gift resulting in a gift tax of, for example, $10,000 may elect to use $9,999 of the credit and pay $1.00 of gift tax. Section 2504(c) would be satisfied and, unless the Internal Revenue Service audited this return, upon expiration of the statute of limitations the value of the gift would be fixed as reported. This provision is thus an obvious ploy to trigger the statute of limitations for gift tax returns the Service would not ordinarily scrutinize.

We note that elective use of the unified credit will have other consequences as well. For example, the basis of property transferred by gift is increased by the gift tax attributable to the net appreciation in the property. By "prepaying" the unified tax through elective use of the credit, the donor is able to achieve a basis adjustment for the gift which it would not otherwise receive.

In addition, the failure to "gross up" the gift tax on gifts made more than three years before death allows that amount of gift tax to be excluded from the donor's gross estate. Thus, any gift tax paid electively on a gift made more than three years before the donor's death would be excluded from the taxable estate.

We are concerned that an elective unified credit would encourage manipulation by astute estate tax counselors. Thus, Treasury does not favor this provision.

Section 8 -- Extension of Estate Tax Payments

Current law provides that where a closely-held business, including a family farm, makes up a significant portion of a decedent's estate, the executor may elect to pay the estate tax attributable to the farm or business in installments over a period of 10 years (section 6166A) or, under a separate provision, a period of 15 years (section 6166). If payment is deferred under section 6166, a special 4 percent interest rate is applicable to the deferred estate tax attributable to the first $1 million of value of the closely held business interest. In addition, current income tax law provides that a qualified redemption of stock to pay estate taxes will be treated as the sale of a capital asset rather than as a dividend.

Sections 6166 and 6166A, which are based on essentially identical policy considerations, contain significantly different requirements as to:

(1) what maximum period of deferral is available,

(2) how much estate tax can be deferred,

(3) how large a closely held business interest must be in relation to the size of the estate in order to qualify for the extension of time for payment,

(4) what constitutes "an interest in a closely held business",

(5) under what conditions two or more interests can be aggregated or combined to meet the applicable threshold requirements,

(6) what rate of interest is payable on the unpaid installments, and

(7) how large a withdrawal from the closely held business or disposition of an interest in the closely held business must be to cause an acceleration of the remaining intallments of estate tax.

The differences in the requirements of these two provisions are difficult to reconcile. Section 6166, which provides greater relief, has qualification requirements which in some respects are more difficult to satisfy than those of section 6166A, but in other respects are easier to satisfy

than those of section 6166A. The 65 percent of the adjusted gross estate threshold requirement of section 6166 appears generally to be more difficult to satisfy than the 50 percent of the taxable estate or 35 percent of the value of the gross estate threshold requirements of section 6166A. However, the rules permitting aggregation of two or more business interests to meet the threshold requirement is more liberal under section 6166, producing the anamolous result that some estates which would not qualify under section 6166A might qualify under section 6166.

In addition, the special rules under section 6166 (treating community property and property which is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common as though the property were owned by one shareholder or one partner, and treating all stock and partnership interests held by the decedent and his family as held by the decedent, as well as the increase from 10 to 15 in the number of partners or shareholders permitted in determining whether there is an interest in a closely held business) expand the definition of an interest in a closely held business, and, in this respect, provide for a potentially broader application of section 6166 than section 6166A.

There appears to be little, if any, reason for the existence of these two different elective extension of time for payment provisions. Moreover, their overlapping jurisdiction may place personal representatives in the position of having to choose between them at the peril of having made the wrong choice if their judgment as to the value of the decedent's interest in a closely held business interest is not sustained.

We concur that it is appropriate to attempt to simplify these sections. Indeed, the Treasury and Joint Committee staffs are currently studying these provisions in detail. Thus, we believe legislation is at this point premature. However, if it is felt that it is appropriate to enact legislation prior to the results of the pending study, we believe a preferable interim solution is reflected in H.R. 4694 as introduced in the first session of this Congress. Under H.R. 4694, the two installment provisions would be replaced with one provision allowing the 15-year installment period. However, the threshold requirements for the new provision would reflect all three of the current rules (65 percent of the adjusted gross estate or 35 percent of the value of the gross estate or 50 percent of the taxable estate), rather than only the latter two which are currently

in the 10-year provision. Further, the special 4 percent interest rate allowed on the estate tax attributable to the first $1 million of farm or other closely-held business property would apply under H.R. 4694 only if the estate meets the 65 percent of adjusted gross estate threshold requirement. Finally, H.R. 4694 would also change the amount of withdrawal or disposition of an interest in a closely-held business which results in acceleration of installments from one-third t· 50 percent. However, H.R. 4694 would not amend either the income tax rules relating to stock redemptions to pay estate taxes or the acceleration which follows if an installment payment of estate tax is overdue.

Section 9: Disclaimers ineffective under state law

The Tax Reform Act of 1976 codified, in section 2518, the circumstances under which a refusal to accept the ownership of property would be treated as a disclaimer (i.e., the disclaimant would not be treated as having transferred the disclaimed property). Previously, the Federal tax requirements for a qualified disclaimer had been stated in regulations and depended in part upon treatment under local law.

Under section 2518, one of the conditions necessary for a qualified disclaimer is that as a result of the disclaimer the property interest passes without any direction on the part of the person making the disclaimer, either to the spouse of the decedent or to a person other than the disclaimant. Proposed Treasury regulations provide, in accordance with our view of the statute, that where a disclaimer is ineffective under state law to divest title from the disclaimant, the disclaimer is not a "qualified disclaimer" for purposes of section 2518. Thus, for example, if state law requires a disclaimer to be made within 6 months of the date the interest is created, a disclaimer made 7 months after that date will not be a qualified disclaimer because under local law the disclaimer does not divest the disclaimant of title to the property.

Section 9 of the bill is intended to reverse this rule. Under the bill, if the disclaimer meets the Federal standards but fails to meet state law requirements it may nevertheless be treated for federal transfer tax purposes as a qualified disclaimer so long as the disclaimant transfers the interest to the one who would have been the recipient of the property if the disclaimant had predeceased the owner of the property. Thus, this amendment creates a Federal rule to determine the time within which a qualified disclaimer must be made.

We do not oppose this amendment. While the bill states the general rule for determining the recipient of disclaimed property under most state laws, we do not know whether all states have adopted this formulation. Thus, we believe it would be appropriate to modify the amendment to provide that it must pass to the person who would have received the property had the disclaimer been effective under state law.

I would be pleased to answer any questions you may have.

The next two witnesses will be Robert M. Bellatti, Illinois State Bar Association, and Donald W. Thurmond, American Bankers Association.

Welcome, gentlemen.

STATEMENT OF ROBERT M. BELLATTI, ILLINOIS STATE BAR ASSOCIATION

Mr. Bellatti. Thank you very much, Mr. Chairman.

My name is Robert M. Bellatti. I am tax attorney, specializing in estate planning and administration, and I am chairman of the federal taxation section of the Illinois State Bar Association. I am here today on behalf of the Illinois State Bar Association, and its 20,000 member attorneys to speak generally in support of Senate bill 2967.

Before beginning my statement, I would like to highly commend Senators Nelson, Byrd, Wallop and Eagleton for their sponsorship of this bill. The sponsors of this bill have very eloquently stated the reasons why this legislation is desperately needed by family farms and small businesses.

In order to preserve small business as a vital part of our free enterprise economy, the enactment of estate and gift tax relief provisions of the type contained in this legislation are absolutely necessary. Any revenue loss to the Government that occurs as a result of these relief provisions will be very small when compared to our total Federal budget, and should be viewed as a necessary expenditure for the preservation of family business enterprise.

The increase in the unified credit under section 2 of the bill is an entirely appropriate recognition of the drastic impact that inflation has had on the estate tax burden for small businesses. Increasing the unified credit to the equivalent of an exemption of $500,000 in 1985 is not inconsistent with a policy of limiting the accumulation of wealth through the transfer tax system.

An Illinois farm that is today worth $500,000 may generate less than $15,000 of annual net income to the owner. Transferring this farm to the next generation does not result in the type of wealth accumulation the transfer tax system was designed to limit.

Section 3 of the bill provides for an unlimited marital deduction for both estate and gift tax purposes. Eliminating all estate and gift taxes on transfers between spouses would remove from the Federal law one of the major sources of irritation that exists between our citizens and the Government.

It is contrary to the very nature of the marital relationship to require an accounting down to the penny for the money which each spouse has paid for the property they have jointly acquired during their marriage. From my experience in counseling hundreds of married couples about the present estate and gift tax law, I am deeply impressed with the outrage that they feel when they learn that there are grave tax consequences arising from the manner in which they hold title to assets between themselves, and from the manner in which they provide for each other in their wills.

By providing for an unlimited marital deduction, this bill would eliminate the ridiculous requirement that the surviving spouse must prove his or her money contribution to the acquisition of

jointly held assets in order to shelter them from being taxed in the first estate.

Perhaps more importantly the surviving spouse will not have the great emotional loss of a loved one compounded by the forced liquidation of assets to pay an unexpected and large estate tax bill.

Although we do support the unlimited marital deduction, we would also support an increase in the current marital deduction limitations in the event that the unlimited marital deduction is not enacted. For example, the current estate tax marital deduction is limited to the greater of $250,000, or 50 percent of the adjusted gross estate. This limitation might be increased to the greater of $500,000 or 50 percent of the adjusted gross estate, and this same higher limitation should also be made applicable for gift tax purposes.

Our only comment about the increase in the annual gift tax exclusion from $3,000 to $6,000 is that it is long overdue, and not large enough. As Senator Wallop noted in his statement when the bill was introduced, the annual gift tax exclusion should be set at approximately $14,000 to simply keep up with the inflation that has occurred since 1943 when the $3,000 amount was established.

Even with the $6,000 amount under the proposed bill, a parent could not give a child a new American-made car without filing a gift tax return. We support this section of the bill, but we would even more enthusiastically support increasing the amount of the annual gift tax exclusion to at least $10,000.

Section 5 of the bill contains a number of provisions which make the special use valuation provisions more workable and equitable. In my testimony today, I will not attempt to discuss all of the special use valuation provisions in the bill.

In general, we feel that these provisions in the bill would be very helpful in making special use valuation more workable and equitable. I would like to specifically mention a few of these provisions and indicate our strong support for their enactment.

The provisions eliminating the material participation requirement for retired or disabled owners of small businesses or farms will eliminate the extremely difficult dilemma that confronts such owners under the current law. Presently such owners face the difficult choice between retiring and collecting social security benefits that are rightfully theirs, or continuing to work so that they can qualify for the special use valuation.

It was certainly not the intention of Congress to make the owners of small businesses forfeit their social security benefits in order to obtain this much-needed estate tax relief.

The bill would also remove the $500,000 limitation on the amount of the valuation reduction that is permitted under special use valuation. Once again, the tremendous inflation that we are experiencing makes an increase in the $500,000 limitation necessary. However, it is entirely possible that both from a revenue and policy standpoint Congress should consider maintaining a limitation at some higher level such as $1 million.

The primary purpose of special use valuation is to prevent forced sales of small family farms and businesses to pay estate taxes, rather than to encourage investment in specific real property assets by larger businesses and outside investors.

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Perhaps the most important special use valuation provision in the bill is the provision that will permit crop share data to be used in applying the cash rental formula in the case of farms located in areas where all comparable farms are rented on a crop share basis rather than for cash rent.

The crop share provision in this bill is superior to similar provisions in other bills that have been introduced because it specifically permits reference to areawide averages of crop share data. In the absence of such specific statutory language, the Treasury could impose by regulation the extremely onerous and often impossible task of obtaining specific data from a particular neighboring farmer for the 5-year period preceding death.

This net share rental provision should be enacted in 1980 as an emergency measure to bring the benefits of section 2032A to States such as Kansas, and even some areas of Illinois, where no farms are rented on a cash basis and the IRS is denying all 2032A elections presently.

Another extremely important provision is the bill would provide for an increase in the qualified heirs basis in a farm that is originally qualified for special use valuation, and then later subjected to recapture tax. The current law imposes an extremely harsh and unintended basic penalty when property that is originally qualified for special use valuation is later subject to a recapture tax through cessation of qualified use.

Section 8 of the bill contains a number of desirable changes in the installment payment of estate tax sections of the Internal Revenue Code. While we generally support this part of the bill, we feel that an additional provision is necessary in order to permit the retired sole proprietor to qualify for these beneficial installment payment provisions.

I might add that a very large majority of all farms are operated on a sole proprietor basis, and I presume that at least a very large proportion of other businesses are also operated in a sole proprietor form.

The IRS is currently taking the position that the deceased sole proprietor must have been personally active in the business in the few months preceding death in order to qualify the estate for the installment payment election. This results in an unintended denial of the installment payment benefits to small farms and businesses operated in the proprietorship form.

At the present time the only way that the sole proprietor can qualify his estate for installment payment of estate tax is to die prematurely before retirement from the active business operation. Even if the proprietor's child is actively continuing the business, the proprietor's estate will not qualify for installment payment of estate tax if the proprietor lives his normal life expectancy and experiences the normal disabilities of the last few years of life.

The way in which the installment payment provisions could be amended to provide the intended benefit to a sole proprietor's estate would be to allow a family member's activities to be attributed to the proprietor for purposes of determining whether the active trade or business requirement is met.

In summary, we believe that this bill contains many worthwhile and desirable improvements in the estate and gift tax law. We do

feel that great care must be taken to eliminate any technical flaws in the bill during the legislative process.

Additional time is needed to study the bill and be sure that all of the results of its provisions are understood and intended. We respectfully request the opportunity to submit an additional written statement after we have had more time to review the provisions of the bill. We feel that some of the effective dates that are currently in the bill may need adjustment to carry out the purposes of the bill.

The Illinois State Bar Association is pleased to have had the opportunity to testify at this hearing today, and looks forward to providing the subcommittee with any assistance it can render in connection with this legislation.

Thank you.

Senator BYRD. Thank you, sir.

[The prepared statement of Mr. Bellatti follows:]

STATEMENT OF ILLINOIS STATE BAR ASSOCIATION
RE S.2967 AT HEARING OF SENATE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT ON AUGUST 4, 1980

My name is Robert M. Bellatti. I am a tax attorney specializing in estate planning and administration and I am Chairman of the Federal Taxation Section of the Illinois State Bar Association. I am here today on behalf of the Illinois State Bar Association to speak generally in support of Senate Bill 2967. This bill was introduced in July, 1980 by Senators Nelson, Byrd, Wallop and Eagleton and is titled "The Family Enterprise Estate and Gift Tax Equity Act".

In my testimony today I will make some general observations about the specific provisions contained in this bill. During the next few weeks we will submit an additional written statement containing our technical commentary on the bill. My general observations today are based upon the assumption that the legislative process will correct any technical defects contained in the current draft of the bill.

The sponsors of this bill have very eloquently stated the reasons why this legislation is desparately needed by family farms and small businesses. In order to preserve small businesses as a vital part of our free enterprise economy, the enactment of estate and gift tax relief provisions of the type contained in this legislation are absolutely necessary. Any revenue loss to the government that occurs as a result of these relief provisions will be very small when compared to our total federal budget and should be viewed a necessary expenditure for the preservation of family business enterprise.

I will now make some general observations about some of the specific provisions in the bill.

Increase in Unified Credit

The increase in the unified credit under Section 2 of the bill is an entirely appropriate recognition of the drastic impact that inflation has had on the estate tax burden for small businesses. Increasing the unified credit to the equivalent of an exemption of $500,000 in 1985 is not inconsistent with the policy of limiting the accumulation of wealth through the transfer tax system. An Illinois farm that is today worth $500,000 may generate less than $15,000 of annual net income to the owner. Transferring this farm to the next generation does not result in the type of wealth accumulation that the transfer tax system was designed to limit.

Unlimited Marital Deduction

Section 3 of the bill provides for an unlimited marital deduction for both estate and gift tax purposes. Eliminating all estate and gift taxes on transfers between spouses would remove from the federal tax law one of the major sources of irritation that exists between our citizens

and our government. It is contrary to the very nature of the marital relationship to require an accounting down to the penny for the money which each spouse has paid for property that they have jointly acquired during their marriage. From my experience in counselling hundreds of married couples about the present estate and gift tax law, I am deeply impressed with the outrage they feel when they learn that there are grave tax consequences arising from the manner in which they hold title to assets between themselves and from the manner in which they provide for each other in their Wills.

By providing for an unlimited marital deduction, this bill would eliminate the ridiculous requirement that the surviving spouse must prove his or her monetary contribution to the acquisition of jointly held assets in order to shelter them from being taxed in the first estate. Perhaps more importantly, the surviving spouse will not have the great emotional loss of a loved one compounded by the forced liquidation of assets to pay an unexpected and large estate tax bill.

The only real concern that we have about the unlimited marital deduction is that some persons having relatively modest estates may unintentionally create a larger estate tax burden in passing the property on to the next generation by fully utilizing the marital deduction on the first estate. For example, assume that this bill is enacted in its present form and that our decedent dies in 1985 having an estate of $1,000,000. If the decedent's Will leaves the entire estate to the spouse, then there will be no estate tax on the decedent's estate because of the unlimited marital deduction. However, if the surviving spouse dies one year later with the $1,000,000 estate, there will be an estate tax of approximately $190,000. If our decedent who died in 1985 had only left $500,000 to his spouse and given the spouse a life estate in the other $500,000, then there would still have been no tax on our decedent's estate and there would also have been no tax on the surviving spouse's estate. Thus the full use of the unlimited marital deduction in this example generated an unnecessary tax of $190,000 on the second estate.

Although we do support the unlimited marital deduction, it would also be a great improvement over current law if the minimum amount of marital deduction was increased from $250,000 to at least $500,000, and if that same minimum marital deduction amount was made available for gift tax purposes as well as estate tax purposes.

Increase in Annual Gift Tax Exclusion

Our only comment about the increase in the annual gift tax exclusion from $3,000 to $6,000 is that it is long overdue and not large enough. As Senator Wallop noted in his statement when the bill was introduced, the annual gift tax exclusion should be set at approximately $14,000 to simply keep up with the inflation that has occurred since 1943 when the $3,000 amount was established. Even with the $6,000 amount under the proposed bill, a parent could not

give a child a new American-made car without filing a gift tax return! We support this provision of the bill, but we would even more enthusatically support increasing the amount of the annual gift tax exclusion to at least $10,000.

Section 2032A Special Use Valuation of Certain Real Property

Section 5 of the bill contains a number of provisions which make the special use valuation provisions more workable and equitable. The Tax Reform Act of 1976 added Section 2032A to the Internal Revenue Code to provide for special use valuation of family farms and closely-held business real property. According to the Committee Reports in 1976, the purpose of special use valuation was to reduce the number of forced sales of family farms and other small businesses to pay estate taxes. The traditional method of valuing farm or business real estate for estate tax purposes reflects speculation to such a degree that the tax value placed on the land does not bear a reasonable relationship to its earning capacity.

In my testimony today I will not attempt to discuss all of the special use valuation provisions in the bill. In general we feel that these provisions in the bill would be very helpful in making special use valuation more workable and equitable. I would like to specifically mention a few of these provisions and indicate our strong support for their enactment.

The provisions eliminating the material participation requirement for retired or disabled owners of small businesses or farms will eliminate the extremely difficult dilemma that confronts such owners under the current law. Presently such owners face the difficult choice between retiring and collecting social security benefits that our rightfully theirs, or continuing to work so that they can qualify for the special use valuation. It was certainly not the intention of Congress to make the owners of small businesses forfeit their social security benefits in order to obtain this much needed estate tax relief.

The bill would also remove the $500,000 limitation on the amount of the valuation reduction that is permitted under special use valuation. Once again the tremendous inflation that we are experiencing makes an increase in the $500,000 limitation absolutely necessary. However, it is entirely possible that both from a revenue and policy standpoint Congress should consider maintaining a limitation at some higher level, such as $1,000,000. The primary purpose of special use valuation is to prevent forced sales of small family farms and businesses to pay estate taxes, rather than to encourage investment in specific real property assets by larger businesses.

The bill contains a much needed provision to permit a Section 1031 trade or exchange of farm or business real estate that occurs after the decedent's death and within the special use valuation recapture tax period. This provision would permit the trade of farm real estate that has been specially valued in exchange for other farm real

estate without generating a recapture tax if the trade is exempt from capital gains tax under Section 1031. A similar provision should be added to the bill to permit Section 1031 exchanges by the family prior to the decedent's death without forfeiting the holding period of the property traded away for purposes of qualifying for special use valuation. The current letter ruling position of the IRS makes this latter additional provision necessary.

Perhaps the most important special use valuation provision in the bill is the provision that would permit crop share data to be used in applying the cash rental formula in the case of farms located in areas where all comparable farms are rented on a crop share basis rather than for cash rent. The crop share provision in this bill is superior to similar provisions in other bills that have been introduced, because it specifically permits reference to area-wide averages of crop share data. In the absence of such specific statutory language, the Treasury Department could impose by regulation the extremely onerous and often impossible task of obtaining specific data from a particular neighboring farmer for the five year period preceding death.

Another extremely important provision in the bill would provide for an increase in the qualified heir's basis in a farm that is originally qualified for special use valuation and then later subjected to the recapture tax. Current law imposes an extremely harsh and unintended basis penalty when property that is originally qualified for special use valuation is later subject to a recapture tax through cessation of qualified use.

Election to Pay Gift Tax

Section 7 of the bill would make the unified credit elective for gift tax purposes. A taxpayer could elect to pay gift tax rather than use up part of the taxpayer's unified credit in order to start the statute of limitations running for valuation purposes. This provision in the bill should be amended to specify that this voluntary payment of gift tax would result in a binding determination of the value of the gift for estate tax purposes as well as for the purpose of determining the amount of gift tax on subsequent gifts. This provision is necessary in order to make reasonable planning possible under our unified transfer tax system.

Installment Payment of Estate Tax

Section 8 of the bill contains a number of desirable changes in the installment payment of estate tax sections of the Internal Revenue Code. While we generally support this part of the bill, we feel that an additional provision is necessary in order to permit the retired sole proprietor to qualify for these beneficial installment payment provisions. The IRS is currently taking the position that the deceased sole proprietor must have been personally active in the business in the few months preceding death in order to qualify the estate for the installment payment election. This is an absurd and totally unjustifably denial of installment payment benefits to small farms and businesses operated in the proprietorship form. At the present time the only way

that the sole proprietor can qualify his estate for installment payment of estate tax is to die prematurely before retirement from the active business operation. Even if the proprietor's child is actively continuing the business, the proprietor's estate will not qualify for installment payment of estate tax if the proprietor lives his normal life expectancy and experiences the normal disabilities of the last few years of life.

The way in which the installment payment provisions could be amended to provide the intended benefit to a sole proprietor's estate would be to allow a family member's activities to be attributed to the proprietor for purposes of determining whether the active trade or business requirement is met.

Summary

As we stated at the beginning of our testimony, we believe that this bill contains many worthwhile and desirable improvements in the estate and gift tax law. We do feel that great care must be taken to eliminate any technical flaws in the bill during the legislative process. Additional time is needed to study the bill to be sure that all of the results of its provisions are understood and intended. We respectfully request the opportunity to submit an additional written statement after we have had more time to review the provisions of the bill. We feel that some of the effective dates that are currently in the bill may need adjustment to carry out the purposes of the bill.

The Illinois State Bar Association is pleased to have had the opportunity to testify at this hearing today and looks forward to providing the subcommittee with any assistance it can render in connection with this legislation.

MEMORANDUM

RE: Explanation of Provisions of Section 5 of S.2967 Amending Internal Revenue Code Section 2032A

Section 5(a) of the bill provides for exceptions to the material participation requirements during the eight-year period prior to the decedent's death. The bill in its present form would add three exceptions to Section 2032A(b). The first exception is for decedents who were retired or disabled at the time of their death. This exception provides that the date of retirement or the beginning of disability would be treated as the date of death for purposes of determining whether the five out of eight year prior to death material participation requirement has been met.

The revised bill eliminates the other two exceptions to the material participation requirement that are included in Section 5(a) of the bill in its present form. The exception for spouses who receive qualified real property has been eliminated because it would allow special use valuation for real property that was purchased immediately before the death of the decedent and left to a spouse that actively managed the farm until the spouse's death. There would be much opportunity for abusive use of special use valuation under this exception. Likewise, the exception for woodlands has been eliminated from the revised bill for the reason that abusive estate tax sheltering might result from such a special statutory provision. It is believed that legitimate hardship cases can be adequately handled through Treasury Department regulations and reasonable administration by the IRS.

Section 5(b) of the bill shortens the required holding period after death from 15 years to 10 years and provides certain limited exceptions to the material participation requirements for the qualified heir or family member after the decedent's death. The only change made in these provisions by the revised bill is to eliminate the special exception to the material participation requirement for woodlands. It is believed that a 10-year holding period requirement after death is sufficient to prevent abuse of the special use valuation provisions. It is also believed that a lesser amount of business involvement could be required after the decedent's death where the qualified heir is the spouse of the decedent, a minor, a student or a disabled person. However, it is not believed that special statutory exception is needed for woodlands for the reasons stated in the preceding paragraph.

Section 5(c) of the bill in its present form would entirely eliminate the $500,000 limitation on the reduction in value permitted under Section 2032A. It is believed that Section 2032A was intended to provide estate tax relief to the smaller family farm, and that the total elimination of a limitation on the amount of the value reduction available under Section 2032A would lead to an unintended concentration of land holding in the extremely large family farming operations. However, it would be appropriate to increase the $500,000 limitation amount to $650,000 for estates of decedents dying in 1981 to reflect the inflation that has occurred since 1976 (when the $500,000 amount was established). Further, the limitation amount should be indexed for decedents dying after 1981 to reflect the inflation or deflation that occurs in land values.

Section 5(d) of the bill would permit qualified real property which has been valued under Section 2032A to be exchanged in a Section 1031 transaction for other real property without triggering a recapture tax under Section 2032A. The real property received in the Section 1031 transaction would be subject to the same restrictions and potential recapture tax treatment as the qualified real property prior to the Section 1031 transaction. The only change in this provision under the revised bill is to clarify that the real property received in the Section 1031 transaction must be used for exactly the same qualified use that the qualified real property was used for.

Section 5(e) of the bill eliminates the requirement that qualified heirs make a special election to receive the benefits of Section 2032A(h) when an involuntary conversion occurs. The revised bill makes no change in this provision.

Section 5(f) of the bill provides that the Section 2032A(e)(7) cash rental formula is available even if no reasonably comparable farms in the same locality are rented for cash. The Treasury Department interpretation of the current law would not permit the use of the (e)(7) formula in such cases. The bill would permit reference to net share rentals from reasonably comparable land when applying the (e)(7) formula in such cases. The bill in its present form would further permit references to area-wide averages of net share rentals published by certain federal or state agencies, instead of requiring reference to actual net share rentals received on reasonably comparable land in the same locality. However, such data would be indicative only of the income from an "average" farm in the area and at the present time such statistics on area-wide averages are not available in most areas of the nation. For these reasons the revised bill eliminates the reference to area-wide averages, although the Treasury Department could by regulation permit reference to such averages where reliable statistics are available.

The revised bill also makes an important change in the method of valuation under Section 2032A(e)(7). A new subparagraph (C) would permit the executor to elect to have the farm valued under (e)(7) at 60% of the farm's fair market value (value determined without reference to Section 2032A), rather than the value determined under the mathematical formula.

Section 5(f) of the revised bill also is intended to clarify the fact that data from reasonably comparable real property may be referred to in the application of all of the valuation methods under Section 2302A. This clarification has been necessitated by reports of IRS agents in some areas of the country taking the position that reference cannot be made to a comparable farm unless it is exactly identical to the subject farm. For example, in one case it was understood that an agent argued that the farm was not comparable because the grass on its pasture was mowed to a different height than the grass on the pasture land in the subject farm.

Section 5(g) of the bill provides that in the event that the estate tax that was initially saved by electing Section 2032A valuation is recaptured under the provisions of Section 2032A(c), then the qualified heir may elect to have his basis in the property increased under Section 1014 to what the qualified heir's basis in the property would have been if Section 2032A had not been elected. If the qualified heir does elect to receive the increase in basis, then interest on the recapture tax must be paid from the date on which the decedent's estate tax was due under Section 2001 to the date that the recapture tax is paid. Once the basis penalty under Section 2032A is eliminated, interest should be imposed for the period of deferral of the estate tax in the event that a recapture event occurs, in order to deter abusive use of Section 2032A to obtain interest-free deferral of estate tax payment.

Section 5(h) of the revised bill has been added to permit Section 2032A valuation of real property that has been received in a Section 1031 exchange within the eight-year period prior to the death of the decedent. This provision would in effect permit the tacking of the ownership, qualified use and material participation periods with respect to the property transferred in a Section 1031 transaction to such periods with respect to the property received in the transaction. The property received would have to be used in the same qualified use as the property transferred had been. If only a portion of the property transferred in the transaction was qualified exchange property, then the tacking would be permitted with respect to only a portion of the real property received in the transaction.

Section 5(i) of the revised bill is added to clarify the qualified use requirement with respect to farm property. The final regulations issued by the Treasury Department on July 31, 1980 appeared to require that in order to satisfy the qualified use requirement, the decedent personally must have had an at risk or equity interest in the farming operation. Section 5(i) of the revised bill would overrule this provision of the final regulations.

Section 5(j) of the revised bill is added to clarify the fact that the executor may elect Section 2032A valuation on any part or all of the qualified real property. The final regulations issued by the Treasury Department on July 31, 1980 require that the executor must elect Section 2032A valuation on a portion of the qualified real property having an adjusted value equal to or greater than 25% of the adjusted value of the gross estate. Section 5(j) of the revised bill would overrule this provision of the final regulations.

Section 5(k) of the revised bill would clarify the manner in which the amount of recapture tax is calculated when only a portion of the property which has been valued under Section 2032A ceases to be used in a qualified use. This provision in the revised bill would limit the amount of the recapture tax to the same proportion of the total potential recapture tax as the value of the property ceased to be used in a qualified use bears to the total value of all property valued under Section 2032A.

Section 5(l) of the revised bill has been added to expand the definition of family member to include relatives of the decedent's or qualified heir's spouse. This will permit Section 2032A valuation on property left to a decedent's spouse where a brother of the decedent is the farm tenant on the property, for example. This expanded definition of family members is needed to make Section 2032A valuation available to many small family farming operations.

Section 5(h) of the bill in its present form has been redesignated Section 5(m) of the revised bill. Section 5(m) of the revised bill provides for different effective dates for the various sections of the bill. Sections 5(a), (c), (f), (h), and (l) of the revised bill are to be effective for estates of decedents dying after December 31, 1980. The other sections of the revised bill are to be effective for estates of decedents dying after December 31, 1976.

1.

5

9 SEC. 5. VALUATION OF CERTAIN FARM, ETC., REAL
10 PROPERTY.
11 (a) DEFINITION OF QUALIFIED REAL PROPERTY.—
12 Subsection (b) of section 2032A (defining qualified real prop-
13 erty) is amended by adding at the end thereof the following
14 new paragraph:
15 "(4) RETIRED AND DISABLED DECEDENTS.—
16 "(A) IN GENERAL.—If, on the date of death
17 of the decedent, the decedent did not otherwise
18 meet the requirements of paragraph (1)(C) with
19 respect to any property, and the decedent—
20 "(i) was eligible to receive old-age
21 benefits under title II of the Social Security
22 Act, or
23 "(ii) was disabled for a continuous
24 period ending on such date,

6

1 then paragraph (1)(C) shall be applied by substituting
2 'the date on which the decedent became eligible to re-
3 ceive old-age benefits under title II of the Social Secu-
4 rity Act or became disabled' for 'the date of the dece-
5 dent's death'.

2.

6 "(B) DISABLED DEFINED.—For purposes of
7 subparagraph (A), an individual shall be disabled
8 if such individual has a mental or physical impair-
9 ment which renders him unable to materially par-
10 ticipate in the operation of the farm or other busi-
11 ness.
12 "(5) SPECIAL RULE FOR SPOUSES WHO ARE
13 QUALIFIED HEIRS.—In the case of any qualified real
14 property which was acquired by a qualified heir who is
15 the spouse of the decedent and which does not other-
16 wise meet the requirements of paragraph (1)(C) upon
17 the death of such spouse, such real property shall be
18 treated as meeting the requirements of paragraph
19 (1)(C) if such spouse was engaged in the active man-
20 agement of the operation of the business at all times
21 during—
22 "(A) the 10-year period ending on the date
23 of death of the spouse, or

7

1 "(B) the period beginning on the date of
2 death of the decedent and ending on the date of
3 death of the spouse.

3.

4 "(6) SPECIAL RULE FOR CERTAIN WOOD-
5 LANDS.—In the case of real property used for a farm-
6 ing purpose described in subparagraph (C) of subsection
7 (e)(5) which does not otherwise meet the requirements
8 of paragraph (1)(C), such real property shall be treated
9 as meeting the requirements of paragraph (1)(C) if, at
10 all times during the 10-year period ending on the date
11 of the decedent's death—
12 "(A) such real property was owned by the
13 decedent or a member of the decedent's family
14 and used for such farming purpose, and
15 "(B) the decedent or a member of the dece-
16 dent's family was engaged in the active manage-
17 ment of the operation of the business.".
18 (b) DISPOSITIONS AND FAILURES TO USE FOR QUALI-
19 FIED USE.—
20 (1) 10-YEAR HOLDING PERIOD.—
21 (A) IN GENERAL.—Subsection (c) of section
22 2032A (relating to tax treatment of dispositions
23 and failures to use for qualified use) is amended—

1 (i) by striking out "15 years" in para-
2 graph (1) and inserting in lieu thereof "10
3 years", and
4 (ii) by striking out paragraph (3) and re-
5 designating paragraphs (4) through (7) as
6 paragraphs (3) through (6).
7 (B) CONFORMING AMENDMENTS.—Para-
8 graph (2) of section 2032A(h) (relating to treat-
9 ment of replaced property) is amended—
10 (i) by striking out in subparagraph (A)
11 all that follows "involuntarily converted,"
12 and inserting in lieu thereof the following:
13 "except that with respect to such qualified
14 replacement property the 10-year period
15 under paragraph (1) of subsection (c) shall be
16 extended by any period, beyond the 2-year
17 period referred to in section 1033(a)(2)(B)(i),
18 during which the qualified heir was allowed
19 to replace the qualified real property,", and
20 (ii) by striking out "(7)" in subpara-
21 graph (C) and inserting in lieu thereof "(6)".
22 (2) CESSATION OF QUALIFIED USE.—
23 (A) IN GENERAL.—Paragraph (6) of section
24 2032A(c) (defining cessation of qualified use), as

1 redesignated by paragraph (1), is amended to read
2 as follows:
3 "(6) CESSATION OF QUALIFIED USE.—For pur-
4 poses of paragraph (1)(B)—
5 "(A) IN GENERAL.—Real property shall
6 cease to be used for the qualified use if—
7 "(i) such property ceases to be used for
8 the qualified use set forth in subparagraph
9 (A) or (B) of subsection (B)(2) under which [handwritten: b]
10 the property qualified under subsection (b), or
11 "(ii) except as provided in subparagraph
12 (B), during any period of 8 years ending
13 after the date of the decedent's death and
14 before the date of the death of the qualified
15 heir, there has been periods aggregating 3
16 years or more during which—
17 "(I) in the case of periods during
18 which the property was held by the de-
19 cedent (other than periods during which
20 the decedent was an individual de-
21 scribed in subsection (B)(4)(A) (i) or (ii)),
22 there was no material participation by
23 the decedent or any member of the decedent's
24 family in the operation of the farm or
25 other business, and

6.

1 "(II) in the case of periods during
2 which the property was held by any
3 qualified heir, there was no material
4 participation by such qualified heir or
5 any member of his family in the oper-
6 ation of the farm or other business.
7 "(B) 10-YEAR ACTIVE MANAGEMENT.—If
8 an eligible qualified heir elects, at such time and
9 in such manner as the Secretary may presecribe,
10 to have the provisions of this subparagraph apply
11 to any real property—
12 "(i) the provisions of clause (ii) of sub-
13 paragraph (A) shall not apply to such proper-
14 ty, and
15 "(ii) such property shall cease to be
16 used for the qualified use if the fiduciary or
17 the eligible qualified heir or any member of
18 his family did not take part in the active
19 management of the farm or other business at
20 all times during the period beginning on the
21 date of death of the decedent and ending on
22 the earlier of—
23 "(I) the date of death of the quali-
24 fied heir, or

7.

11

1 "(II) the date which is 10 years
2 from date of death of the decedent.
3 "(C) ELIGIBLE QUALIFIED HEIR.—For pur-
4 poses of this paragraph, the term 'eligible quali-
5 fied heir' means—
6 ~~"(i) any qualified heir with respect to~~
7 ~~real property the qualified use for which is a~~
8 ~~farming purpose described in subparagraph~~
9 ~~(C) of subsection (e)(5), and~~
10 ~~"(ii) in any other case,~~ a qualified heir
11 who, on the date of death of the decedent—
12 "(I) is the spouse of the decedent,
13 "(II) has not attained the age of
14 21,
15 "(III) is a student described in
16 subparagraph (A) or (B) of section
17 151(e)(4), or
18 "(IV) was disabled (within the
19 meaning of subsection (b)(4)(B)) for a
20 continuous period ending on such
21 date.".
22 (B) CONFORMING AMENDMENT.—Subsection
23 (e) of section 2032A (relating to definitions and
24 special rules) is amended by adding at the end
25 thereof the following new paragraph:

8.

1 "(12) ACTIVE MANAGEMENT.—The term 'active
2 management' means the making of the management
3 decisions of a business (other than the daily operating
4 decisions).".

Paragraph (2) of

5 (c) REPEAL OF $500,000 LIMITATION.—Subsection (a)
6 of section 2032A (relating to value based on use under which
7 property qualifies) is amended to read as follows:
8 ~~"(a) VALUE BASED ON USE UNDER WHICH PROP-~~
9 ~~ERTY QUALIFIES.—If—~~
10 ~~"(1) the decedent was (at the time of his death) a~~
11 ~~citizen or resident of the United States; and~~
12 ~~"(2) the executor elects the application of this~~
13 ~~section and files the agreement referred to in subsec-~~
14 ~~tion (d)(2),~~
15 ~~then, for purposes of this chapter, the value of qualified real~~
16 ~~property shall be its value for the use under which it quali-~~
17 ~~fies, under subsection (b), as qualified real property."~~

"(2) LIMITATION.-- The aggregate decrease in the value of qualified real property taken into account for purposes of this chapter which results from the application of paragraph (1)

with respect to any decedent shall not exceed $650,000. For estates of decedents dying after December 31, 1981, the aggregate decrease in value allowed under this paragraph shall be indexed to the Consumer Price Index prepared by the Department of Labor. The indexing required under the preceding sentence shall be computed for each calendar year by multiplying the amount allowed under this paragraph for the prior calendar year by a fraction. The numerator of the fraction shall be the Consumer Price Index as of January 1 of the calendar year. The denominator of the fraction shall be the Consumer Price Index as of January 1 of the prior calendar year."

18 (d) EXCHANGE OF QUALIFIED REAL PROPERTY.—
19 (1) IN GENERAL.—Section 2032A (relating to
20 valuation of certain farm, etc., real property) is amend-
21 ed by adding at the end thereof the following new sub-
22 section:
23 "(i) EXCHANGES OF QUALIFIED REAL PROPERTY.—
24 "(1) TREATMENT OF PROPERTY EXCHANGED.—

1 "(A) IN GENERAL.—If an interest in quali-
2 fied real property is exchanged—
3 "(i) no tax shall be imposed by subsec-
4 tion (c) on such exchange if the interest in
5 qualified real property is exchanged solely
6 for an interest in qualified exchange property
7 in a transaction which qualifies under section
8 1031(a), or
9 "(ii) if clause (i) does not apply, the
10 amount of the tax imposed by subsection (c)
11 on such exchange shall be the amount deter-
12 mined under subparagraph (B).

11.

13 "(B) AMOUNT OF TAX WHERE PROPERTY
14 RECEIVED IS NOT SOLELY AN INTEREST IN
15 QUALIFIED EXCHANGE PROPERTY.—The amount
16 determined under this subparagraph with respect
17 to any exchange is the amount of tax which (but
18 for this subsection) would have been imposed on
19 such exchange reduced by an amount equal to
20 that portion of such tax which is attributable to
21 the amount of the interest in qualified exchange
22 property received by the taxpayer.
23 "(2) TREATMENT OF QUALIFIED EXCHANGE
24 PROPERTY.—For purposes of subsection (c)—

1 "(A) any interest in qualified exchange prop-
2 erty shall be treated in the same manner as if it
3 were a portion of the interest in qualified real
4 property which was exchanged, and
5 "(B) any tax imposed by subsection (c) on
6 the exchange shall be treated as a tax imposed on
7 a partial disposition.
8 "(3) QUALIFIED EXCHANGE PROPERTY.—For
9 purposes of this subsection, the term 'qualified ex-
10 change property' means real property which is to be

12.

subparagraph (A), (B), or (C)
same of subsection (e)(5) or

11 used for the qualified use set forth in subparagraph (A)
12 or (B) of subsection (b)(2) under which the real prop-
13 erty exchanged therefor originally qualified under sub-
14 section (a).".
15 (2) CONFORMING AMENDMENTS.—
16 (A) Paragraph (1) of section 2032A(f) (relat-
17 ing to statute of limitations) is amended—
18 (i) by inserting "or exchange" after
19 "conversion",
20 (ii) by inserting "or (i)" after "(h)", and
21 (iii) by inserting "or of the exchange of
22 property" after "replace".
23 (B) Paragraph (2) of section 6324B(c) (relat-
24 ing to special liens) is amended by inserting "and
25 qualified exchange property (within the meaning

15

1 of section 2032A(i)(3))" before the period at the
2 end thereof.
3 (e) ELECTION REQUIREMENT OF SPECIAL RULES FOR
4 INVOLUNTARY CONVERSIONS REPEALED.—Section 2032A
5 (h) (relating to special rules for involuntary conversions of
6 qualified real property) is amended—

7 (1) by striking out "and the qualified heir makes
8 an election under this subsection" in paragraph (1)(A);
9 and
10 (2) by striking out paragraph (5).
11 (f) METHOD OF VALUING FARMS.—
12 (1) NET SHARE RENTALS.—
13 (A) IN GENERAL.—Paragraph (7) of section
14 2032A(e) (relating to method of valuing farms) is
15 amended by ~~redesignating~~ striking out subparagraph (B) ~~as~~
16 ~~subparagraph (C)~~ and by inserting after subpara-
17 graph (A) the following new subparagraph~~s~~:
18 "(B) VALUE BASED ON NET SHARE RENTAL
19 IN CERTAIN CASES.—
20 "(i) IN GENERAL.—If there is no reasonably com-
21 parable land from which the average annual
22 gross rental may be determined, subpara-
23 graph (A)(i) shall be applied by substituting
24 'average annual net share rental' for 'average annual gross
25 cash rental'.

1 "(ii) NET SHARE RENTAL.—For pur-
2 poses of this paragraph, the term 'net share
3 rental' means the excess of—

4 "(I) the value of the produce re-
5 ceived by the lessor of the land on
6 which such produce is grown, over
7 "(II) the cash operating expenses
8 of growing such produce which, under
9 the lease, are paid by the lessor.
10 "(iii) DETERMINATION OF AVERAGE
11 NET SHARE RENTAL.—For purposes of this
12 subparagraph, the average net share rental
13 shall be—
14 "(I) the average net share rental
15 for reasonably comparable land pub-
16 lished by the Department of Agricul-
17 ture, an agency of the State in which
18 the land is located, or a college or uni-
19 versity of such State (within the mean-
20 ing of section 511(a)(2)(B)), or
21 "(II) if the average described in
22 subclause (I) is not available, the aver-
23 age net share rental determined on the
24 basis of comparable land located in the
25 locality of such farm.".

(C) ELECTION TO VALUE FARM BASED ON PERCENTAGE DISCOUNT.-- The executor may elect to have the value of a farm for farming purposes determined by multiplying--

(i) the value of the qualified real property for purposes of this chapter (determined without regard to this section), by

(ii) 60 percent.

(D) EXCEPTION.-- The formula provided by subparagraph (A) shall not be used--

(i) where it is established that there is no comparable land from which the average annual gross cash rental (or average annual net share rental under subparagraph (B)) may be determined,

(ii) where the executor elects to have the value of the farm for farming purposes determined under subparagraph (C), or

(iii) where the executor elects to have the value of the farm for farming purposes determined under paragraph 8.

(E) EXCEPTION.-- The formula provided by subparagraph (C) shall not be used--

"(i) where the executor elects to have the value of the farm for farming purposes determined under subparagraph (A), or

(ii) where the executor elects to have the value of the farm for farming purposes determined under paragraph 8."

16.

17

1 ~~(B) CONFORMING AMENDMENTS.~~

2 (i) Clause (i) of section 2032A(e)(7)(C)

3 (as redesignated by subsection (a)) is amend-

4 ed by inserting ", or where it is established

5 that the average net share rental is not capa-

6 ble of being determined under subparagraph

7 (B)(iii)" after "determined".

8 (ii) Subparagraph (A) of section 2032A

9 (e)(7) is amended by striking out "subpara-

10 graph (B)" and inserting in lieu thereof "sub-

11 paragraph (C)".

(B) CONFORMING AMENDMENT.-- Subparagraph (A) of section 2032A(e)(7) is amended by striking out "subparagraph (B)" and inserting in lieu thereof "subparagraph (D)".

12 (2) COMPARABLE SALES.—Subparagraph (D) of

13 section 2032A(e)(8) (relating to method of valuing

14 closely held business interests, etc.) is amended by

15 striking out "Comparable" and inserting in lieu thereof

16 "Reasonably comparable".

17 (g) BASIS UPON RECAPTURE. Paragraph (3) of sec-
18 tion 1014(a) (relating to basis of property acquired from a
19 decedent) is amended by inserting "(increased by the value of
20 any interest in such property (determined for purposes of this
21 chapter without regard to this section) with respect to which
22 an additional estate tax is imposed under section
23 2032A(c)(1))" after "section".

1 (h) EFFECTIVE DATE. The amendments made by this
2 section shall apply to the estates of decedents dying after
3 December 31, 1981.

(g) ELECTION TO INCREASE BASIS UPON RECAPTURE.--

(1) ELECTION BY QUALIFIED HEIR.-- Subsection (c) of section 2032A is amended by adding at the end thereof the following new paragraph:

"(7) ELECTION TO INCRASE BASIS.-- If a qualified heir who is personally liable for the additional tax imposed by this subsection files an election, in accordance with regulations prescribed by the Secretary, the basis of the qualified heir's interest in the qualified

real property subject to such additional tax shall be adjusted in the manner provided in paragraph (3) of section 1014(a)."

(2) ELECTIVE BASIS UPON RECAPTURE.-- Paragraph (3) of section 1014(a) (relating to basis of property acquired from a decedent) is amended to read as follows:

"(3) in the case of an election under section 2032A, its value determined under such section, increased by the value of any interest in such property (determined for purposes of this chapter without regard to this section) with respect to which an additional estate tax is imposed under section 2032A(c)(1) and the qualified heir has filed an election under section 2032A(c)(7)."

(3) INTEREST ON RECAPTURE TAX.-- Paragraph (5) of subsection (c) of section 2032A is amended to read as follows:

"(5) DUE DATE.-- The additional tax imposed by this subsection shall become due and payable on the day which is 6 months after the date of the disposition or cessation referred to in paragraph (1), but, if the election under paragraph (7) of this subsection is filed by the qualified heir, then for purposes

of section 6601, interest on such additional tax shall be paid from the time prescribed in chapter 62 for payment of the tax imposed by section 2001 on the decedent's estate to the date such additional tax is paid."

(h) TACKING OF HOLDING PERIOD OF QUALIFIED EXCHANGE PROPERTY.-- Subsection (b) of section 2032A is amended by adding at the end thereof the following new paragraph:

"(5) QUALIFIED EXCHANGE PROPERTY.--

(A) IN GENERAL.-- For purposes of subparagraph (C) of paragraph (1) of this subsection, periods with respect to qualified exchange property during the 8-years preceding the decedent's death may be aggregated with periods with respect to the real property included in the decedent's gross estate.

(B) QUALIFIED EXCHANGE PROPERTY.-- For purposes of this paragraph, the term "qualified exchange property" means real property--

(i) which was used for the same qualified use set forth in subpara-

graph (A), (B), or (C) of subsection (e)(5) or subparagraph (B) of subsection (b)(2) under which the real property exchanged therefor qualifies under subsection (a), and

(ii) which was exchanged for an interest in real property included in the gross estate of the decedent in a transaction which qualifies under section 1031.

(C) WHERE PROPERTY RECEIVED IS NOT SOLELY QUALIFIED REAL PROPERTY.-- Where the property received in a transaction which qualifies under section 1031 is not solely qualified real property (after the application of subparagraph (A) of this paragraph), then subparagraph (A) of this paragraph shall apply only to the qualified real property received in such transaction.

(D) WHERE REAL PROPERTY IS RECEIVED NOT SOLELY IN EXCHANGE FOR QUALIFIED EXCHANGE PROPERTY.-- Where property other than qualified exchange property is exchanged for qualified real property (after the application of subparagraph (A) of this paragraph) in a transaction which qualifies under section 1031, subparagraph (A) of this paragraph shall apply only to an

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undivided fraction of the real property received in such transaction. The numerator of the fraction shall be equal to the value of the qualified exchange property on the date of such transaction. The denominator of the fraction shall be equal to the value on the date of such transaction of the real property received in the transaction."

(i) CLARIFICATION OF QUALIFIED USE REQUIREMENT.-- Paragraph (2) of subsection (b) of section 2032A is amended to read as follows:

"(2) QUALIFIED USE.-- For purposes of this section, the term "qualified use" means the devotion of the property to any of the following:

(A) use as a farm for farming purposes (whether or not the use is in a trade or business), or

(B) use in a trade or business in which the use of the propety is other than for farming purposes."

(j) CLARIFICATION OF ELECTION REQUIREMENT.-- Subparagraph (B) of paragraph (1) of subsection (a) of section 2032A is amended to read as follows:

"(B) the executor elects the application of this section to any part or all of the qualified real property and files the agreement referred to in subsection (d)(2),".

(k) CLARIFICATION ON PARTIAL DISPOSITIONS.-- Subparagraph (D) of paragraph (2) of subsection (c) of section 2032A is amended to read as follows:

"(D) PARTIAL DISPOSITIONS.-- For purposes of this paragraph, where the qualified heir disposes of a portion of the interest acquired by (or passing to) such heir (or a predecessor qualified heir) or there is a cessation of use of such a portion--

(i) The term 'such interest' in subparagraph (c)(2)(A)(i) means the portion of the interest disposed of or to which there is a cessation of use,

(ii) the value determined under subsection (a) taken into account under subparagraph (A)(ii) with respect to such portion shall be its pro rata share of such value of such interest, and

(iii) the adjusted tax difference attributable to the interest taken into account with respect to the transaction involving the second or any succeeding portion shall be reduced by the amount of the tax imposed by this subsection with respect to all prior transactions involving portions of such interest."

(l) INCLUSION OF MEMBERS OF SPOUSE'S FAMILY.-- Paragraph (2) of subsection (e) of section 2032A is amended to read as follows:

"(2) MEMBER OF FAMILY.-- The term "member of the family" means, with respect to any individual, only such individual's ancestors or lineal descendants, a lineal descendant of a grandparent of such individual, the spouse of such individual, the individual's spouse's ancestors or lineal descendants, a lineal descendant of a grandparent of such individual's spouse, or the spouse of any such descendant. For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as a child of such individual by blood."

(m) EFFECTIVE DATES.-- The amendments made by paragraphs (a), (c), (f), (h) and (l) of this section shall apply to the estates of decedents dying after December 31, 1980. The amendments made by paragraphs (b), (d), (e), (g), (i), (j) and (k) of this section shall apply to the estates of decedents dying after December 31, 1976.

Senator BYRD. Mr. Thurmond.

STATEMENT OF DONALD W. THURMOND, AMERICAN BANKERS ASSOCIATION

Mr. THURMOND. Mr. Chairman, and Senator Bentsen.

My name is Donald W. Thurmond. I am the chairman of the taxation committee of the trust division of the American Bankers Association and group vice president of the Trust Company Bank in Atlanta, Ga.

The American Bankers Association is a trade association composed of more than 13,100 banks, over 90 percent of the full service banks in the country. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Thus, the association is keenly interested in any changes that might be made in Federal estate and gift taxation.

The ABA appreciates the opportunity to present its views on the Family Enterprise Estate and Gift Tax Equity Act, S. 2967. There is a need to reexamine the Federal estate and gift tax laws in terms of the level of taxation, inflation, and the adverse effects on family-owned and closely held businesses. Although we have not been furnished any revenue estimates, it is clear that this proposal will result in a tax reduction. As a general proposition, the ABA believes:

One. Any tax cut should be matched by a reduction in expenditures sufficient to prevent an increase in the Federal deficit; and

Two. The reduction should be designed to encourage savings, investments, technological advances and innovative activity rather than consumption. We believe it is appropriate to consider a reduction in estate tax and gift tax within these guidelines.

Although my remarks today will be brief and by no means comprehensive, I would like to convey to this committee the support of the ABA for the general thrust of S. 2967. There is a need to address the liquidity problems and capital formation needs of family farms and closely held businesses.

Further, there is a need to provide estate tax relief in order to accommodate for the inflation that has occurred. In this regard, the bill does address several major areas of concern such as an increase in the unified credit, increase in the gift tax annual exclusion, improvements in the so-called special use valuation rules for family farms and a merger of the estate tax deferred payment section 6166 and 6166A into a single section.

The ABA believes that comprehensive tax legislation such as proposed requires the benefit of extensive review. We should not approach the problems of an unresponsive and complex law in a piecemeal fashion in light of the broad nature of this proposal and the obvious need for estate tax relief.

The ABA respectfully requests that this committee afford us an opportunity to submit a detailed statement at a later date. The short time between introduction of the bill and this hearing is not enough to thoroughly review and analyze the proposal, and additional time is needed.

Senator BYRD. How much time do you think would be needed?

Mr. THURMOND. I think that we would need at least a month in order to file an additional statement.

Senator BYRD. Why don't both of you submit additional comment as early as practical.

Mr. THURMOND. All right, sir.

We are prepared at this time, though, to endorse many of the major features of S. 2967.

It is clear there is need for an increase in the unified credit. In fact, it was clear in 1976 that the level of credit passed was not adequate to account for the inflation that had occurred since the original $60,000 exemption.

The annual gift tax exclusion has been inadequate for a number of years, and an increase is definitely needed. One might question whether this increase is sufficient to account for inflation.

Section 2032A of the Internal Revenue Code, relating to special estate tax valuation for certain farms and real property, became part of the law in 1976. The general explanation of the Tax Reform Act prepared by the staff of the Joint Committee on Taxation clearly indicates that it was the intent of Congress in enacting section 2032A to alleviate the estate tax burden on farms and closely held businesses, and making it feasible for the heirs of these enterprises to continue to use the property for farming and other small business purposes. However, an inflationary economy combined with a complex and narrowly defined law has resulted in affording little or no relief to the affected taxpayers.

The Family Enterprise and Estate and Gift Tax Equity Act significantly reforms and clarifies section 2032A. We support these changes. Although many of the problem areas of section 2032A are addressed, we suggest that the measure does not go far enough. Under present law every person who has or might have an interest in property which may qualify for 2032A treatment must sign a consent agreement electing special use valuation for the property. The Internal Revenue Service requires that the consent agreement be filed at the time the estate tax return is filed.

It is not unusual that an executor cannot locate a party who may have an interest in the property, or that the person is either unwilling to sign the agreement because his interest is so remote or the person does not possess the legal capacity—a minor or an incompetent.

In addition, at the time the estate agreement must be filed, the executor may not know who is going to receive the property, or who is going to have to sign the consent agreement.

It is our recommendation that the decedent should be able to waive this requirement. If he does not waive this requirement, then the beneficiaries with the current beneficial interest in the property should be the only ones required to file the agreement. Also a consent agreement should be considered timely filed if filing occurs during the statute of limitations period for the estate tax return.

The value of a gift made within 3 years of the decedent's death should, for the purpose of inclusion in the decedent's estate, be valued as of the date of transfer, and not again for estate tax purposes. This represents needed simplification.

During the past several months sections 6166 and 6166A of the Internal Revenue Code relating to the deferral of the payment of estate tax attributable to an interest in a closely held business

have been the subject of much discussion in the private sector. The ABA believes that reform of this aspect of the estate law is essential.

The existence of two deferral provisions with differing requirements creates confusion and uncertainty. Considerable simplification would be achieved by merging the two sections and using as a point of departure the deferral provisions of section 6166.

The Family Enterprise and Gift Tax Equity Act includes a provision that would eliminate some of the duplicative aspects of section 6166 and section 6166A. The ABA supports the concept of conforming the threshold percentage qualification requirements in both sections. However, we are concerned that S. 2967 does not go far enough in reforming the provisions of the estate tax law.

Any proposal to revise these sections should take into account the highly technical and complex nature of the law, and to do so in a comprehensive and thorough manner. We urge the committee to study this provision in greater detail.

In March of this year we submitted a statement to this committee in connection with the hearings held on the impact of the Federal estate tax law on the American family. Attached to our statement was a draft of a memorandum discussing consolidation of section 6166 and section 6166A and suggested other related statutory revisions. We urge the committee to refer to this memorandum in the course of its deliberations on the proposal under consideration.

There is a need to provide simplification and clarity in the provisions covering all closely held businesses. The special use valuation provision is of no real use to a nonfarm closely held business. We ask that the committee take the lead in addressing simplification as outlined in our previous memorandum. We will be pleased to furnish the committee with additional copies of the memorandum if you desire.

The American Bankers Association does not have a position on the unlimited marital deduction. In the past, when this issue has been discussed, we have opposed it. We are now restudying it in light of the current proposal. This is an area that requires considerably more study than is required for the other proposals in the bill.

The estate planning community is just now becoming comfortable with the estate tax changes that occurred in 1976. This type of change will require significantly revised planning for the estates that have just gone through significantly revised planning. How much change or rate of change can we stand?

As opposed to the other changes in the bill, this represents a conceptual change. We think there are a number of questions and considerable study and hearings should be held on this issue. Questions that currently come to mind include:

Will this provision influence transfers in favor of the spouse to the detriment of the other natural beneficiaries? In other words, the decedent's property may be diverted in an unintended direction if the spouse remarries.

Will this provision be used to obtain a perceived tax advantage which may really be a disadvantage when the tax on both estates is taken into account? Use of the provision may result in substan-

tially higher tax liability for the combined estates than we now have under current law.

If a decision is made to enact an unlimited marital deduction, one way of solving some of the problems that we have mentioned would be to permit a current beneficial interest in the property without a general power of appointment to qualify for the marital deduction. We are inclined to believe that a shift to an unlimited marital deduction must be accompanied by a shift to a current beneficial interest qualification test.

We continue to have reservations about such a provision and believe it is in the public's best interest to examine this contemplated change in a more detailed fashion.

S. 2967 does address several items that will affect the overall level of estate and gift tax revenues. If a decision is made to reduce the level of revenue from this source, then consideration should be given to a general reduction in the unified estate and gift tax rates structure. This would give all estates the opportunity to benefit from the tax reduction. We do believe that the rate structure currently is too severe, and a reduction at all levels is desirable.

I appreciate the opportunity to present the views of the American Bankers Association. I would like to emphasize that while S. 2967 does address areas of major concern that need attention, several of the provisions require considerably more study before enactment.

We believe that it is appropriate to consider a reduction in the estate and gift tax. However, any reduction should be designed within the guidelines of reducing expenditures sufficiently to prevent an increase in the Federal deficit and encourage savings, investments, technological advances and innovative activity rather than consumption.

We do offer our technical assistance to the staff in considering any of these provisions. Thank you.

Senator BYRD. Thank you, Mr. Thurmond.

Both you and the Treasury Department have indicated some concern about the unlimited marital deduction proposal.

Mr. THURMOND. Yes, sir.

Senator BYRD. It seems to me that there is justification for concern on both your part and Treasury's part. I would think the committee would want to consider very carefully before adopting this proposed provision.

I gather that if you had to make a decision today, you would be inclined not to go that route. Is that correct?

Mr. THURMOND. That is correct. The current provision, without further study, I think there is danger there.

Senator BYRD. In regard to the overall bill, it seems to me that with the present high inflation rates, and there is no evidence that high inflation will not continue—but even if it is reduced by a third, let's say, or more—a home which is now valued at $70,000, which is somewhat near the average throughout the country, at the end of 20 years with continued inflation at a third less than it is now, would have a valuation of about $420,000. That is just a home.

It seems to me that this is a dramatic example of a need to consider doing something about the estate tax laws at the present time.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

Senator BYRD. Senator Bentsen?

Senator BENTSEN. I am in general accord with what the chairman has said. I would like to get Mr. Thurmond's comments on how much are they utilizing the installment settlement of the estate tax in a closely held family corporation or a farm? How much is it actually being used?

Mr. THURMOND. The experience in my bank is that we use it on every occasion where the opportunity is available. I think that the experience may differ in different parts of the country, but we use it quite extensively.

Senator BENTSEN. You use it on every occasion?

Mr. THURMOND. Yes, sir.

Senator BENTSEN. What is that, 15 years?

Mr. THURMOND. It is 10 years on some of them. Some of them don't qualify for the full 15 years.

Senator BENTSEN. It can get up to 15 years.

Mr. THURMOND. Yes, it can get up to 15 years.

Senator BENTSEN. What is the tax rate?

Mr. THURMOND. It varies.

Senator BENTSEN. What are you paying now in those situations?

Mr. THURMOND. You mean the tax rate?

Senator BENTSEN. I mean the interest rate on the tax.

Mr. THURMOND. Twelve percent generally, and 4 percent under the 15-year provision for the tax on the first million. So there is quite a variance in tax rate.

Senator BENTSEN. Don't you pay 12 percent now on a 15-year settlement?

Mr. THURMOND. Four percent on the tax on the first $1 million, and any amount over that is 12 percent.

Senator BENTSEN. I have had some estate attorneys tell me that they never advise the use of it because they say that you, in effect, give the IRS control over the estate for that period of time. And they don't want to be encumbered with all of the problems they have with the IRS continuing to oversee the management of the estate during that period of time.

Mr. THURMOND. To be perfectly honest, this has not been a problem with us in doing this. They do not take a role in managing the estate or the business in our experience. It may vary from district to district, but I don't know about that.

Senator BENTSEN. Thank you.

Senator BYRD. Thank you, Senator Bentsen, and thank you, gentlemen.

[The prepared statement of Mr. Thurmond follows:]

TESTIMONY OF DONALD W. THURMOND
ON BEHALF OF
AMERICAN BANKERS ASSOCIATION
ON
THE FAMILY ENTERPRISE ESTATE AND
GIFT TAX EQUITY ACT (S. 2967)
BEFORE THE
SUBCOMMITTEE ON TAXATION AN DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

August 4, 1980

Mr. Chairman and Members of the Committee:

My name is Donald W. Thurmond. I am the Chairman of the Taxation Committee of the Trust Division of the American Bankers Association and Group Vice President of the Trust Company Bank, Atlanta, Georgia.

The American Bankers Association (ABA) is a trade association composed of more than 13,100 banks - over 90% of the full service banks in the country. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Thus, the Association is keenly interested in any changes that might be made in Federal estate and gift taxation.

The ABA appreciates this opportunity to present its views on the Family Enterprise Estate and Gift Tax Equity Act, S. 2967. There is a need to re-examine the Federal estate and gift tax laws in terms of the level of taxation, inflation and the adverse effects on family-owned and closely-held businesses. Although we have not been furnished any revenue estimates, it is clear that this proposal will result in a tax reduction. As a general proposition, the ABA believes: (1) Any tax cut should be matched by a reduction in expenditures sufficient to prevent an increase in the Federal deficit; and (2) the reduction should be designed to encourage savings, investments,

technological advances and innovative activity rather than consumption. We believe it is appropriate to consider a reduction in estate tax and gift tax within these guidelines.

Although my remarks today will be brief and by no means comprehensive, I would like to convey to this Committee the support of the ABA for the general thrust of S. 2967. There is a need to address the liquidity problems and capital formation needs of family farms and closely-held businesses. Further, there is a need to provide estate tax relief in order to accommodate for the inflation that has occurred. In this regard, the bill does address several major areas of concern such as an increase in the unified credit, increase in the gift tax annual exclusion, improvements in the so-called special use valuation rules for family farms and a merger of the estate tax deferred payment Sections 6166 and 6166A into a single Section.

The ABA believes that comprehensive tax legislation such as proposed requires the benefit of extensive review. We should not approach the problems of an unresponsive and complex law in a piecemeal fashion in light of the broad nature of this proposal and the obvious need for estate tax relief. The ABA respectfully requests that this Committee afford us an opportunity to submit a detailed statement at a later date. The short time between introduction of the bill and this hearing is not enough to thoroughly review and analyze the proposal. Additional time is needed.

However, the ABA is prepared at this time to endorse many of the major features of S. 2967.

Unified Credit - It is clear there is need for an increase in the unified credit. In fact, it was clear in 1976 that the level of credit passed was not adequate to account for the inflation that had occurred since the original

$60,000 exemption was enacted.

Annual Gift Tax Exclusion - This has been inadequate for a number of years and an increase is definitely needed. One might question whether this increase is sufficient to account for inflation.

Special Use Valuation Rules - Section 2032A of the Internal Revenue Code, relating to special estate tax valuation for certain farms and real property, became law as part of the Tax Reform Act of 1976. The General Explanation of the Tax Reform Act prepared by the Staff of the Joint Committee on Taxation clearly indicates that it was the intent of Congress, in enacting Section 2032A, to alleviate the estate tax burden on farms and closely-held businesses -- making it feasible for the heirs of these enterprises to continue to use the property for farming and other small business purposes. However, an inflationary economy combined with a complex and narrowly defined law has resulted in affording little or no relief to the effected taxpayers.

The Family Enterprise Estate and Gift Tax Equity Act significantly reforms and clarifies Section 2032A. Among other changes, the proposal recognizes the need to specifically authorize the use of net share rentals derived from comparable land in determining the average gross cash rentals in order to qualify for the farm valuation formula pursuant to Section 2032A(e)(7). The Internal Revenue Service proposed amended regulations in September 1979 - regulations which became final on July 31, 1980 - which would disallow the conversion of crop share leases into cash rentals as a method of valuing a farm. Should Section 2032A(e)(7) not be amended as proposed by S. 2967, then in our view, the majority of farm estates eventually will be unable to qualify for the farm valuation formula. The result will be the return to the usual method of valuing farm land under prior law which is based on comparable sales.

Comparable sales valuations will generally include the speculative excesses which Congress intended to eliminate.

S. 2967 also addresses the fact that the material participation requirements of Section 2032A are burdensome and restrictive. The bill would correct present law under which the estate of an individual who was disabled or retired for a period of time prior to death may not be permitted to qualify for the much needed estate tax relief envisioned on Section 2032A.

Although S. 2967 amends many of the problem areas of Section 2032A we would suggest that the measure does not go far enough. Under present law every person who has or may have an interest in property which may qualify for Section 2032A treatment must sign a consent agreement electing special use valuation of the property. The Internal Revenue Service requires the consent agreement be filed at the time the estate tax return is filed (within nine months of the decedent's death). It is not unusual that an executor cannot locate a party who may have an interest in the property or that the person is either unwilling to sign the agreement because his interest is so remote or the person does not possess the legal capacity to sign the agreement (i.e. - a minor or disabled individual). In addition, at the time the estate tax return must be filed an executor may not know who is going to receive the property or who is going to have to sign the consent agreement.

It is our recommendation the decedent should be able to waive the consent agreement requirement. If he does not waive the requirement then the beneficiaries with a current beneficial interest in the property should be the only ones required to file the agreement. Also a consent agreement should be considered timely filed if filing occurs during the statute limitations period for the estate tax return.

Election to Pay Gift Tax - In lieu of applying the unified credit against tax liability an individual should be allowed to elect to pay gift tax. This provision would assist both the Service and an individual because the value on the gift would be set at the time of applying the tax and would not normally be a subject of dispute at a later date.

Gifts Made Within Three Years of Death - The value of the gift made within three years of a decedent's death should, for purposes of inclusion on the decedent's gross estate, be valued as of the date of transfer and not again for estate tax purposes. This represents needed simplification.

Merger of Sections 6166 and 6166A - During the past several months, Section 6166 and Section 6166A of the Internal Revenue Code, relating to the deferral of the payment of estate tax attributable to an interest in a closely-held business, have been the subject of much discussion in the private sector. The ABA believes that reform of this aspect of the estate law is essential. The existence of two deferral provisions with differing requirements creates confusion and uncertainty. Considerable simplification would be achieved by "merging" the two Sections and using as a point of departure the deferral provisions of Section 6166.

The Family Enterprise Estate and Gift Tax Equity Act includes a provision that would eliminate some of the duplicative aspects of Section 6166 and Section 6166A. The ABA supports the concept of conforming the threshold percentage qualification requirements in both Sections. However, we are concerned that S. 2967 does not go far enough in reforming the provisions of the estate tax law.

In March of this year, the ABA submitted a statement to this Committee in connection with a hearing held on the impact of the Federal estate tax law on the American family. Attached to our statement was a draft of a memorandum

discussing consolidation of Section 6166 and Section 6166A and suggested other related statutory revisions. We urge the Committee to refer to this memorandum in the course of its deliberations on the proposal now under consideration. We would be pleased to furnish the Committee with additional copies of the ABA memorandum.

There is a need to provide simplification and clarity in the provisions covering all closely-held businesses. The special use valuation provision is of no real use to a non-farm closely-held business. We ask that this Committee take the lead in addressing simplification as outlined in our previous statement, "Sections 6166 and 6166A and Related Matters - Proposals for Change."

Unlimited Marital Deduction - The American Bankers Association does not have a position on the unlimited marital deduction. In the past, when this issue has been discussed, we have opposed it. We are now restudying it in light of the current proposal. This is an area that requires considerably more study than is required for the other proposals in this bill. The estate planning community is just now becoming comfortable with the estate tax changes that occurred in 1976. This type of change will require significantly revised planning for the estates that have just gone through significantly revised planning. How much change or rate of change can we stand? As opposed to the other changes in this bill, this represents a conceptual change. We think there are a number of questions that need to be addressed and thorough hearings should be held on this issue. Questions that currently come to mind include:

1. Will this provision influence transfers in favor of the spouse to the detriment of the other natural beneficiaries? In other words, the decedent's property may be diverted in an unintended direction if the spouse remarries.

2. Will this provision be used to obtain a perceived tax advantage which may really be a disadvantage when the tax on both estates is taken into account? Use of the provision may result in substantially higher tax liability for the combined estates than we now have under current law.

If a decision is made to enact an unlimited marital deduction, one way of solving some of the problems that we have mentioned would be to permit a current beneficial interest in property without a general power of appointment to qualify for the marital deduction. We are inclined to believe that a shift to an unlimited marital deduction must be accompanied by a shift to a current beneficial interest qualification test.

We continue to have reservations about such a proposal and believe it is in the public's best interest to examine this contemplated change in a more detailed fashion.

Estate Tax Reduction - The proposal does address several items that will affect the overall level of estate and gift tax revenue. If a decision is made to reduce the level of revenue, then consideration should be given to a general reduction in the estate tax rate structure. This would give all estates the opportunity to benefit from tax reduction. We do believe the rate structure is too severe and a reduction at all levels is desirable.

Conclusion

I appreciate having the opportunity to present the views of the American Bankers Association. I would like to emphasize that while S. 2967 does address areas of major concern that need attention, several of the provisions require considerably more study before enactment. We believe it is appropriate to consider a reduction in estate and gift tax. However, any reduction should be designed within the guidelines of reducing expenditures sufficient to prevent an increase in the Federal deficit and encourage savings, investments, technological advances and innovative activity rather than consumption.

Thank you.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION ON THE FAMILY ENTERPRISE ESTATE AND GIFT TAX EQUITY ACT (S. 2967) AND ON S. 2775 SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT COMMITTEE ON FINANCE UNITED STATES SENATE

September 11, 1980

This written statement on S. 2967, the Family Enterprise Estate and Gift Tax Equity Act, and on S.2775, relating to retirement and similar plans maintained by nonresident aliens, is filed on behalf of the Trust Division of the American Bankers Association (ABA) pursuant to permission granted at the August 4, 1980 hearing of the Subcommittee on Taxation and Debt Management of the Committee on Finance. The ABA is a trade association composed of more than 13,100 banks. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Therefore, the ABA is keenly interested in any proposed changes in federal estate and gift taxation.

S. 2967 - The Family Enterprise Estate and Gift Tax Equity Act.

We believe a need exists to reexamine the federal estate and gift tax laws in terms of the level of taxation, inflation and adverse effects on family-owned and closely-held businesses. In our oral testimony at the August 4th hearing, the ABA stated its belief that in general (1) any tax reduction should be matched by a reduction in expenditures sufficient to prevent an increase in the federal deficit and (2) the reduction should be

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designed to encourage savings, investments, technological advances and innovative activity rather than consumption. In our opinion, S. 2967 satisfies test (2). Since the bill does not contain any matching reduction in expenditures, test (1) is not satisfied. The estimated revenue loss from S. 2967 in fiscal 1985 would be $3.3 billion, of which $3 billion would be attributable to a single proposed change, namely, an increase in the unified credit for gift and estate taxes to exempt from these taxes transfers by any individual of up to $500,000. The comments that follow on each of the proposed changes in S. 2967 assume that matching reductions in expenditures will be accomplished. In summary, we would allocate the reduction of $3.3 billion in a different manner than is done in S. 2967, with rate reduction for all estates that would be subject to the federal estate tax.

Section 2 - Increase in the Unified Credit

As mentioned above, the unified credit would be increased over a period of years to exempt from estate and gift taxes transfers of $500,000. This represents an increase of $325,000 and gives complete relief from estate and gift taxes to a substantial majority of estates from these taxes. The ABA favors an increase in the unified credit but also believes that rate reduction for estates that would continue to be subject to estate and gift taxes is appropriate. Assuming that a tax reduction of $3 billion is available for estate and gift taxes,

we would favor an increase in the unified credit from the tax on $175,000 to the tax on $250,000 with the balance of the reduction being used for rate reduction. In the absence of a case being made that the rate relief should be targeted at specific levels, each rate should be reduced by the same percent.

Section 3 - Unlimited Marital Deduction

S. 2967 would create an unlimited maritial deduction for estate and gift tax purposes. Under current law, an unlimited marital deduction exists only for smaller estates. The revenue considerations involved in the suggested change are not significant because the deduction permits a postponement of tax but not an avoidance of tax.

During the past ten years the ABA has opposed an unlimited gift and estate tax marital deduction. At the same time our organization supported increasing the marital deduction for "smaller" estates. The Tax Reform Act of 1976 change made in the estate tax marital deduction -- to increase this deduction from one-half of a decedent's adjusted gross estate to the greater of $250,000 or one-half of the adjusted gross estate -- adopted the suggestion that we made in testifying before the House Ways and Means

Committee in early 1976.

We support S. 2967 insofar as (1) the gift tax marital deduction is "conformed" to the estate tax marital deduction and (2) the amount of this deduction is increased, but we continue to believe that an unlimited deduction for larger estates is undesirable. A ceiling should be placed on the deduction. When considered together with the increase in the unified credit which we recommended above, this would mean that an estate of as much as $500,000 would not have to pay any federal estate tax if the decedent was survived by a spouse and took advantage of the maximum marital deduction.

Our primary reason for opposing an unlimited gift and estate tax marital deduction for larger estates is that the change would lead to undesirable dispositions of property within members of an individual's family. A complete exemption from tax for transfers to a spouse would encourage such transfers at the expense of transfers to other members of the tranferor's family. This encouragement would substantially increase tranfers to spouses, even in cases where the income from the entire estate is not needed to maintain the spouse. Faced with

the choice between paying an immediate tax of say 50% or more on property transferred to other family members or no tax on the same property if transferred to the spouse, we believe many if not most decedents would choose to avoid the immediate payment of tax. The tax "pull" would simply be too significant to resist, even though the net tax result in the estates of both spouses would be a larger estate tax as a result of the tax being imposed upon entirely in one estate instead of being split between two estates.

A solution has been suggested for avoiding the undesirable intrusion of an unlimited marital deduction into family estate planning. It is to change the marital deduction qualification requirements so that a current beneficial interest in property will qualify for the deduction. Stated another way, the present requirement that the spouse be given the unrestricted right to dispose of the property would be eliminated. This change would permit the transferor to direct the disposition of the property qualifying for the marital deduction at the spouse's death and would be particularly helpful in cases of second marriages and children of a first marriage where

the transferor desires that property be transferred to his descendants at his spouse's death.

Unfortunately, a change to a current beneficial interest test has problems of its own which are of such nature that we would not favor an unlimited marital deduction if coupled with this test. The marital deduction was added to the estate and gift tax law in 1948 to bring about a closer parity of treatment for spouses in common law states with separate property and those in other states with community property. The enactment of a current beneficial interest qualification test with an unlimited marital deduction would, as before 1948, result in substantial disparity between spouses in common law and community property states because in community property states the surviving spouse has complete control over her or his interest in the community property. This point was made by the Treasury in its statement on S.2967. Also, we may expect that enactment of a current beneficial interest test would involve some "technical" requirements that will have to be met. Based upon our experience with the current terminable interest rule under the marital deduction, this means years of litigation while these requirements are fine-tuned (refined). Finally, this rule would produce more conflict between the

surviving spouse and remainderman over what is an appropriate level of income.

We have other reasons for not favoring an unlimited marital deduction. As noted above, this change could result in an increase in the aggregate estate taxes in the combined estates of the spouses because the entire property of both spouses would be taxed in the estate of the surviving spouse. In order to permit such a result to be avoided, an election would have to be given to the estate of the first to die or to the surviving spouse to have any part of the property eligible for the marital deduction to be taxed in the estate of the first to die. S.2967 does not contain such an election. The creation of the election would create further complexity in an already complex area. An unlimited marital deduction would also create a greater inconsistency between the estate tax law and the applicable elective share laws of common law states where the spouse's share is typically one-third or one-half of the estate.

Section 4 - Annual Gift Tax Exclusion

This section would increase the gift tax annual exclusion for present interest gifts from $3,000 to $6,000 per person. In general, the exclusion is used for significant amounts only by donors with large estates.

We believe rate reduction is more desirable for these estates than an increase in the exclusion, but nevertheless would favor an unlimited gift tax annual exclusion for transfers to a dependent that are used to meet the living expenses of elderly and infirm family members and the educational expenses of family members. This would bring the law into conformity with what is being done. In general, gift tax returns are not being filed for such transfers.

In its testimony on August 4th, the Treasury referred to an increase from $3,000 to $6,000 as permitting "massive transfer tax avoidance". We disagree with this statement, bearing in mind the estimated revenue loss is only $60 million per year after allowing for the proposed increase in the unified credit.

Section 5 - Amending Section 2032A

Section 2032A was enacted as a part of the Tax Reform Act of 1976 and permits a special valuation method to be used in valuing farms for estate tax purposes if certain requirements are met. The section is in our judgment defective in many respects. S.2967 would make changes in section 2032A and improve its effectiveness. These changes, some of which should be noncontroversial, have been opposed by the Treasury, and include permitting

crop share rentals to be used in the section 2032A(e)(7) formula when no cash rentals for comparable land are available. The final regulations under section 2032A have recently been issued and do not permit the use of crop share rentals in any case. As a result many farm estates are denied the benefit of the use of the section 2032A(e)(7) formula because when cash rentals are not available for comparable land the farm must be valued at fair market value. The ABA supports this change.

We also believe the modification of the stringent material participation requirement proposed by S.2967 to permit farms held by elderly disabled or retired farmers or their spouses is desirable and support the other technical changes in section 2032A that are contained in S.2967. We suggest that a further change be made in the section. Under current law, every person who has or may have an interest in section 2032A property must sign a consent agreement electing special use valuation. Recently issued final regulations interpret this requirement in a literal manner and require that the agreement be filed with the estate tax return. Treas. Reg. §20.2032A-8(a)(3) and (c). The regulations do not contain a "good faith" rule to cover the case where the consent of one or more persons is not obtained before the return is due to be filed. A "mistake"

in ascertaining the necessary parties apparently means the use of section 2032A is invalidated. This problem would be solved by permitting consents to be filed after the estate tax return is filed, provided a reasonable cause test is satisfied. The ABA also believes that a decedent should be permitted to waive the consent agreement requirement. We recognize that these proposals present some technical problems if section 2032A(c) becomes applicable and an additional estate tax is imposed and would be pleased to work with staff members in their resolution.

Our concern with section 2032A has been and continues to be the valuation distinction that it creates between farms and other closely-held businesses. We believe such a distinction is unwarranted. The distinction would be broadened rather than narrowed by S.2967 through the removal of the $500,000 limitation on the decrease in value resulting from section 2032A. In 1976 we suggested a means of creating the same type of estate tax relief for farms and other closely-held businesses. This would be done by granting a partial forgiveness for estate tax deferred under section 6166. We continue to believe that such an approach is desirable.

Section 6 - Section 2035 Transfers

This section would achieve simplification by "freezing" the estate tax value of property transferred by a decedent within three years of death at its gift tax value, thus eliminating the necessity of revaluing the property at death. The "freezing" could increase or decrease the tax when compared with current law. The ABA supports this change which has a slight negative revenue impact even though we recognize that in some cases tax savings may be achieved which are hard to justify. See, for example, Revenue Ruling 79-75, 1979-1 Cum. Bull. 294.

Section 7 - Gift Tax Election

Under current law, use of the unified credit is mandatory for gifts. As a result, a taxpayer cannot obtain a binding determination of value for gift tax purposes until the credit has been used up and a gift tax is paid. See section 2504(c). This is not troublesome when the gift is cash or marketable securities because no valuation problem exists. However, if closely-held stock or real property is involved, the valuation of such property is necessarily uncertain or imprecise and therefore gifts of such property present a problem that is not present with other gifts because of the lack of valuation finality until a gift is paid.

Section 7 would make the use of the unified credit elective. The Treasury asserts an elective unified credit "would encourage manipulation by astute estate tax counselors." We disagree and support section 7, which has insignificant revenue consequences. The ABA also recommends that a related problem be eliminated. Section 2504(c) provides in essence that if a gift tax has been paid for a calendar quarter and the statute of limitations has expired then the valuations reported on the return (as adjusted in audit or in litigation) are final for later application of the gift tax to subsequent gifts. As a result of the Tax Reform Act of 1976, the estate tax and the Chapter 13 tax on certain generation-skipping transfers are computed "on top of" an individual's taxable gifts. Section 2504(c) should therefore be revised to accord finality for any valuation in computing a prior gift or estate tax where a later gift, estate or Chapter 13 tax is computed "on top of" the prior tax.

Section 8 - Merger of Sections 6166 and 6166A

During the past several months, sections 6166 and 6166A, relating to the deferral of the payment of estate tax attributable to an interest in a closely-held business, have been the subject of much discussion. The

ABA believes that reform of this aspect of the estate tax law is essential. The existence of two deferral provisions with differing requirements creates confusion and uncertainty. Considerable simplification would be achieved by "merging" the two sections and using as a point of departure the deferral provisions of section 6166.

Section 8 of S.2967 would merge sections 6166 and 6166A by (i) using the lower threshold percentage qualification requirements of section 6166A and (ii) all other provisions of section 6166. We support the merger concept, but urge that other changes be made to make the deferral provisions more useful. We are attaching to this statement the latest version of an ABA memorandum captioned "Sections 6166 and 6166A and Related Matters - Proposals for Change" dated August 27, 1980 which contains a number of suggestions for increasing the utility of the deferral provisions.

S. 2775 - Exemption of Foreign Pension Plans From Certain Provisions of ERISA

The ABA urges the adoption of S. 2775 relating to retirement and similar plans maintained for nonresident aliens. Such plans maintained outside the United States primarily for the benefit of nonresident aliens are excluded from the general funding requirements of Title I

of ERISA. However, the tax rules of ERISA contain provisions which could prevent a plan, whose participants are primarily nonresident aliens, from meeting the standards for deductibility. United States rules dictated by the U.S. social policy concerns should not deny deductions for payments of retirement or pension benefits required by, or made in accordance with, foreign rules and systems. Frequently, a foreign subsidiary or branch may be unable to comply with U.S. tax rules because of the application of the different rules of the foreign jurisdiction. In applying normal accrual rules based on actuarial determinations in accordance with generally accepted accounting standards, the bill would allow U.S. taxable income and accumulated profits to approximate foreign taxable income to avoid potential double taxation of international income.

August 27, 1980

MEMORANDUM OF AMERICAN BANKERS ASSOCIATION

Re: Sections 6166 and 6166A and Related Matters - Proposals for Change

A. Introduction

The operation of §§6166 and 6166A, relating to the deferral of the payment of estate tax attributable to an interest in a closely held business, is troublesome in a number of respects. In addition, other statutory provisions add to the liquidity problems of, or create other problems for, a decedent's estate which consists of one or more interests in closely held businesses. The purpose of this memorandum is to discuss the sources of concern and make recommendations for change. In considering these recommendations, we would emphasize that the deferral provisions do not reduce taxes but only extend the period of payment. As a result, we believe the proper approach is to broaden the application of these provisions.

Each of these sections permits an executor to extend the time for payment of the estate tax attributable to closely held business interests, including farms. The amount of the tax that may be deferred in payment is the

net federal estate tax payable times a fraction having a numerator equal to the value of the closely held business interest and a denominator equal to the decedent's adjusted gross estate, viz., the gross estate reduced by "allowable" §2053 and 2054 deductions. Payments are made in equal annual installments over a ten year period. The term "interest in a closely held business" is defined differently in each section. Qualification requirements are imposed by each section.

B. Differences Between Sections 6166 and 6166A

Sections 6166 and 6166A contain significant differences which include the following:

1. Section 6166 has a higher percentage qualification requirement - 65 percent of the decedent's adjusted gross estate - than §6166A -- 35 percent of the decedent's gross estate or 50 percent of his taxable estate.

2. Section 6166 provides for a five year moratorium on the payment of the estate tax attributable to the closely held business. Section 6166A contains no moratorium.

3. A four percent interest rate applicable to the estate tax attributable to the first $1,000,000 of value is available for deferrals under §6166 but not for deferrals under §6166A.

4. The definition of "interest in a closely held business" is more liberal in §6166. Compare §6166(b)(1)(B)(ii) and (C)(ii) with §6166A(c)(2)(B) and (3)(B).

5. Under §6166(b)(2)(B), stock or a partnership interest held by a husband and wife as community

property or as joint tenants, tenants by the entirety or tenants in common is treated as owned by one shareholder or partner. Section 6166A contains no provision dealing with this matter.

6. Section 6166(b)(2)(C) contains a constructive ownership rule where a corporation, partnership, estate or trust holds an interest in a closely held business. Section 6166A contains no such rule.

7. Section 6166(b)(3) provides that for purposes of the 65 percent requirement an interest in a closely held business which is in the business of farming includes an interest in residential buildings which are used by persons engaged in the farming operation. No similar provision is in §6166A.

8. The aggregation rules for interests in more than one closely held business are more liberal under §6166 than under §6166A. Compare §6166(c) with §6166A(d).

9. Under §6166(g)(1)(A), a disposition of one-third or more in value of the eligible interest will accelerate the payment of the deferred tax whereas the figure in §6166A(h)(1)(A) is one-half or more.

10. Under §6166(g)(1)(D) transfers of property from a trust created by the decedent are not considered as a disposition for purposes of accelerating the payment of the deferred tax. No such statement is made in §6166A(h)(1)(D) and the contrary result could occur.

11. The "undistributed net income" rule of §6166(g)(2)(A) refers to any taxable year of the estate ending on or after the due date of the first installment but the same rule in §6166A(h)(2)(A) refers to any taxable year after its fourth taxable year.

C. "Unifying" Sections 6166 and 6166A

The existence of two deferral provisions with differing requirements creates confusion and in some cases

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requires an executor to make a choice when all facts necessary to make an informed decision are not available. Considerable simplification would be achieved by "merging" the two sections. This approach was contained in H.R. 4694, introduced by Representative Fisher in 1979 and captioned the "Carryover Basis Simplification Act of 1979." The consolidation would be achieved by using §6166 with the changes referred to in part D below.

D. Suggested Changes in Unified Approach

1. Post-Death Interest as an Administration Expense under Section 2053

The Service now recognizes that post-death interest (including estate tax interest) allowable as an administration expense under applicable state law is a proper estate tax deduction under §2053. Rev. Rul. 79-252, IRB 1979-34 at 11. When the interest is claimed as an estate tax deduction, the estate tax is reduced. Uncertainty exists as to the amount of the tax because it depends upon the amount of interest, which with deferral under §6166 or 6166A may not be finally determined until many years after the decedent's death.

In order to prevent an estate tax deduction for interest in excess of the amount actually paid, the Service has allowed the deduction only as interest is

paid. The procedure recommended by the Service is described in letter ruling 8022023 and requires the estate to file supplemental information on an estate tax return as interest is paid. When the total of the installment payments exceeds the estate tax, a refund claim may be filed. If the Service and the estate agree to the amount of the over-assessment as shown on the supplemental information return, the amount of the over-assessment will be abated, thus reducing the amount of unpaid tax upon which interest is computed. This procedure is contrary to the purpose of the deferral provisions - since future interest is not allowed in computing the estate tax the annual installments are overstated and are not in equal amounts as required by the statute.

The effect of the Service paying interest on the estate tax refunds attributable to the interest payments made by the estate is to give the estate an undiscounted deduction for future interest payments. Stated another way, although interest is not paid until several years after the decedent's death, the full amount is still allowed as an estate tax deduction, as are all expenses of administration. This result seems questionable.

The problem is more difficult and significant than indicated above. The threshold percentage

qualification requirement under §6166 is related to post-death interest that is paid because this section applies the percentage against an amount that is reduced by deductions that are "allowable" (not allowed) under §2053. The same result may occur under §6166A if the percentage qualification requirement relating to the taxable estate (rather than the gross estate) is used since, in arriving at the taxable estate, "allowed" §2053 deductions are subtracted. All post-death interest is "allowable" under §2053 although it may not be used (allowed) as an estate tax deduction. Thus, at the time an election must be made under §6166 or 6166A, the executor may not know whether the estate is eligible for deferral because the answer will depend upon how much interest will be paid in the future.

Also, in some cases a decedent may have a surviving spouse and make full use of the maximum marital deduction by a formula provision. When this occurs, the amount of the deduction (and the amount included in the surviving spouse's estate) will depend upon the amount of post-death interest claimed as an administration expense under §2053. How is the amount includible in the surviving spouse's gross estate determined when that spouse

dies during the estate tax deferral period used by the decedent's estate and interest after the spouse's death may be involved?

One approach to solving the post-death interest problem would be to deny post-death interest as an administration expense under §2053. This solution is unsatisfactory because it is unfair. In many cases, the interest paid cannot be used fully as an income tax deduction since it exceeds the gross income of the estate reduced by other deductions other than the distribution deduction. The likelihood of such a result is increased by a high interest rate. From February 1, 1980 through January 31, 1982 this rate will be 12%. Also, use of the interest as an income tax deduction may create distortion in the interests of different beneficiaries because the benefit of the income tax deduction reduces the taxable income of beneficiaries who do not bear the burden of the interest payment.

We believe a simple solution exists to the post-death interest problem. The denial of an estate tax deduction for the interest should be combined with a grant of forgiveness of the interest at a stated rate and with a lower threshold percentage qualification requirement to

reflect the "loss" of the interest deduction. The forgiveness rate would be the highest estate tax rate applicable to the estate, which would be the benefit to the estate if the interest were claimed as an estate tax deduction. Since the forgiveness does not occur until the interest becomes payable, the estate does not get the benefit of a current estate tax deduction for a future payment as occurs under current law. The estate would, of course, still be able to pay the "full" amount of all or any part of the interest and use that amount as an income tax deduction.

The forgiveness would be applicable to any interest on federal income, gift or estate tax of the decedent. This approach would not be applied to interest on a state tax of the decedent, whether income, gift or estate tax, or other interest that would qualify as an administration expense under applicable state law. Thus, the forgiveness would not be applicable to interest on a bank loan obtained to permit payment of the estate tax. Based upon the experience of our member banks, very few estates obtain bank loans to pay the estate tax. We are not bothered by creating a distinction which favors interest on a federal tax as compared with other interest when the application of the federal estate tax is involved.

An example may be helpful in indicating how the forgiveness approach would operate. Assume that an annual interest payment on the unpaid balance of the deferred tax was $15,000 and that the estate's marginal estate tax rate was 39%, applicable to taxable estates of between $750,000 and $1,000,000. The executor could secure a forgiveness of 39% of that part of the $15,000 which was not claimed as an income tax deduction. If the executor claimed $5,000 (of the $15,000) as an income tax deduction, the payment of interest would be $11,100 ($5,000 + 6,100).

As noted, the forgiveness would be based upon the rate schedule in §2001(c), which is applicable in determining the tax before the allowance of credits. Except for the state death tax credit, the credits are rarely applicable. With respect to the state death tax credit, we believe the correct result is that the forgiveness should be based upon the "gross" federal tax. If an estate tax refund were allowed for post-death interest, the refund would be computed using the rate schedule in §2001(c) except when the state death credit rate changes when the interest is subtracted in computing the taxable estate. The method of computing the forgiveness is the same as that contained in H.R. 4694 to determine the basis increase for death taxes attributable to appreciation.

When a marital bequest has been funded pursuant to a maximum marital deduction formula provision, use of the marginal estate tax rate to compute the forgiveness may be said to overstate this amount because, after making allowance for the marital deduction, the taxable estate is reduced by only one-half of the amount of the annual interest payment whereas the forgiveness percentage applies to the entire amount of this payment. However, such an analysis fails to take into account that the amount passing to the surviving spouse is "overstated" and will produce an "additional" estate tax at the spouse's death. These two factors offset each other and collectively are a fair result and certainly one that is preferable to current law.

The suggested approach does not interfere with applicable state law regarding whether estate tax interest is chargeable to income or principal and whether, if the interest is taken as an income tax deduction, an equitable adjustment must be made from income to principal.

2. Threshold Percentage Qualification Requirement

In combining §§6166 and 6166A, H.R. 4694 used the threshold percentage qualification requirements of both sections, thus creating a threefold test of (1) 65

percent of the adjusted gross estate, (2) 35 percent of the gross estate or (3) 50 percent of the taxable estate. The special 4 percent interest rate on the estate tax attributable to the first $1 million of value was available only if the estate met test (1).

Tests (1) and (3) are troublesome because, as noted in subpart 1 above, qualification may depend upon the amount of post-death interest "allowed" or "allowable". This problem is eliminated by excluding post-death interest from consideration. However, without more, such a change would or might increase the threshold requirement if (1) or (3) were used. To avoid this result, the percentages in (1) and (3) should be reduced. A reduction from 65 percent to 50 percent in (1) and from 50 percent to 40 percent in (3) seems appropriate. Use of a 50 percent requirement would achieve conformity with section 303. See discussion below of §303. If these changes are made, test (2) should be eliminated. The likelihood of an estate satisfying this test but not 40% of the taxable estate is remote.

3. Limitation on Amount of Deferred Payment

Section 6166(a)(2) limits the amount of estate tax that may be deferred which, as noted above, is

determined by multiplying the estate tax (after credits) by a fraction having a numerator equal to the value of the closely held business interest and a denominator equal to the adjusted gross estate as defined in §6166(b)(6). Thus, this limitation is uncertain whenever the amount of post-death interest is uncertain. The post-death interest allowable as an estate tax deduction reduces the denominator of the fraction and therefore increases the percentage of the tax deferred in payment.

As in the case of the threshold requirement, the solution is to remove the interest from consideration by modifying the definition of "adjusted gross estate" in §6166(b)(6) to exclude post-death interest.

4. Holding Company Qualification

The present position of the Service is that stock of a holding company cannot "qualify" under §6166 or 6166A unless this company operates a trade or business. Thus, the holding company's ownership of another company which does operate a trade or business is ignored, and form may prevail over substance. Such a result is unsound, particularly when no requirement exists that the trade or business of the holding company constitute a significant part of its assets. A holding company may be

required to maintain the differing equity interests of branches when shifting such interests from an older generation to a younger generation.

Section 6166(b)(1) should be modified to provide in effect that the indirect ownership rule of §6166(b)(2)-(C) applies for the purpose of determining whether the holding company operates a trade or business. If the holding company owns 20% or more of the voting stock of another company operating a trade or business, this trade or business should be attributed to the holding company for the purpose of determining whether the holding company is operating a trade or business.

5. Acceleration of Payment of Deferred Tax

a. Undistributed Net Income Rule

Sections 6166(g)(2) and 6166A(h)(2) contain rules applicable to a decedent's "estate" which requires that, for taxable years ending after a stated time, the executor must pay an amount equal to its undistributed net income in liquidation of the unpaid part of the deferred tax before the due date for the income tax return of the estate covering such year. If the executor fails to make the payment, the entire unpaid portion of the deferred tax may be accelerated by the Service under §6166(g)(3) or

6166A(h)(3). "Undistributed net income" is defined as the estate's distributable net income for the taxable year, as defined in section 643, reduced by the sum of (i) the distribution deductions under section 661(a)(1) and (2), (ii) the amount of the federal estate tax (plus interest) and federal income tax paid by the executor during or for such year.

These provisions create untenable distinctions depending upon what disposition is made of property included in a decedent's gross estate. The undistributed net income rule applies to income on property included in the probate estate but not to income on property included in a revocable trust created by the decedent or to income on property forming a part of a trust created by another person or an irrevocable trust created by the decedent. Thus, the rule is meaningless as to non-probate property.

Also, the rule is of limited significance for probate property. Interest on the deferred tax paid during a particular year reduces the "undistributed net income" at least once, or twice to the extent interest on the deferred tax is claimed as an income tax deduction and thereby reduces the estate's distributable net income. Why should the application of the rule vary depending upon

whether this interest is claimed as an income tax deduction or an estate tax deduction and why should "double dipping" be permitted?

Some states follow the federal lead and permit the state death tax attributable to a closely-held business to be deferred and paid in installments. See e.g., N.Y. Tax Law §962(f); Wis. Stat. Ann. §72.22(4)(a). In such situations, a distinction should not be made between the federal and state tax for purposes of the undistributed net income rule and, in addition, use of the income to pay the state income tax should not be "penalized."

To summarize, in its present form the undistributed net income rule is unsound. It should be modified to meet the points mentioned above or, preferably, be eliminated.

b. Section 6166(g)(1)(D) and Distributions from Trusts

Section 6166(g)(1)(D) should be amended to substitute the words "a trust included in the decedent's gross estate" for "a trust created by the decedent." A marital deduction trust may be included in a decedent's gross estate but will not be created by the decedent. No policy reason exists why in such a case a distribution of

trust property should accelerate the payment of the estate tax on the closely held business interest. Treas. Reg. §20.6166-3(e)(3), in referring to a distribution of an interest in a closely-held business which does not result in an acceleration of the deferred tax, encompasses an interest "which is included in the gross estate under sections 2035 through 2038, or section 2041."

c. Conformity with Section 303

Section 6166(g)(1)(B) states that where a §303 redemption occurs during the deferral period the redemption proceeds are not treated as a disposition of an interest in, or a withdrawal from, the closely held business, which may cause a loss of the deferral privilege, so long as payments of federal estate tax at least equal to these proceeds are made on or before next installment becomes payable. This is an all or nothing rule, with non-compliance causing the entire amount of the redemption proceeds to be treated as a disposition and a withdrawal. See Rev. Rul. 72-188, 1972-1 Cum. Bull. 383. The result should be changed so that only the amount in excess of the "permitted" §303 payments is treated as a disposition.

Sections 303 and 6166 are also "out of phase" because "protected" §303 redemptions may result in

acceleration under §6166. Section 6166(g)(1)(B) refers only to "an amount of tax imposed by Section 2001"* while §303 refers to the federal estate tax and state death taxes (including interest) and funeral and administration expenses. Section 6166(g)(1)(B) should be revised to protect all §303 redemptions. A "use of property" test is unnecessary in §6166(g)(1)(B) because a similar test is contained in §303(b)(4). It directs that in the case of amounts distributed more than four years after a decedent's death §303 applies only to the extent of the lesser of (i) the aggregate §303 unpaid amount immediately before the distribution and (ii) the aggregate §303 amounts paid during the one year period beginning on the date of the distribution.

d. Distribution of Indebtedness

A distribution of indebtedness by a corporation or a partnership in return for a "qualifying" stock or partnership interest is, under §§6166 and 6166A, treated as a distribution or withdrawal in determining whether payment of the deferred tax is accelerated. Section

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* A private letter ruling issued in 1976 holds that the tax imposed by section 2001 includes a state death tax that is allowed as a credit against the federal estate tax pursuant to section 2011.

6166(g) should be modified to eliminate this result as suggested in Recommendation No. 1979-6 of the Tax Section of the American Bar Association. See 32 Tax Lawyer 1464 (1979). This recommendation was approved by the House of Delegates of the Association earlier this year. With closely held business interests, distinctions between indebtedness and equity are inappropriate. Also, under some state laws governing professional partnerships and corporations the interest of the decedent-professional must be redeemed at death. As a result the distribution of indebtedness is to some extent involuntary and similar to a section 303 redemption which receives special treatment under §6166(g)(1)(B).

e. Coordinating Withdrawals and Dispositions

Acceleration of the deferred tax may be caused by a withdrawal from the business or as a result of a disposition of the estate's interest in the business. The withdrawal test is based upon the value of the business. See §§6166(g)(1)(A)(ii) and 6166A(h)(1)(A)(ii). The disposition test applies to the estate's interest in the business. See §§6166(g)(1)(A)(i) and 6166A(h)(1)(A)(i). In each case the percentage is the same, one-third (§6166) or one-half (§6166A). The differing treatment of

withdrawals and dispositions should be eliminated as suggested in Recommendation No. 1979-6 of the Tax Section of the American Bar Association and approved by the House of Delegates of the Association earlier this year. See 32 Tax Lawyer 1464 (1979). The report on the Recommendation states:

> "It is proposed to eliminate the disparate treatment which now exists between the withdrawal and disposition tests by eliminating the withdrawal test as an independent test and by making withdrawals subject to the same limitations as are applicable to dispositions. The disposition test would be further amended to prevent acceleration to the extent that the consideration received in the disposition consists of obligations of the closely held business, since such obligations are not likely to be marketable except at a substantial discount. It is proposed that such a transaction not be considered a disposition that would trigger acceleration. However, the obligations would then in effect take the place of the original interest in the business, so that a subsequent disposition of the specified percentage of the obligations would trigger acceleration."

f. Disposition of Interest or Withdrawal

Section 6166(g)(1) provides that if one-third or more in value of a qualifying closely-held business interest is "distributed, sold, exchanged or otherwise disposed of" payment of the deferred tax is accelerated. In certain cases this rule cannot be justified as a policy matter. To illustrate, let us assume that a decedent left one-third of his qualifying stock to his surviving spouse

in a marital deduction bequest which was not subject to estate tax and the other two-thirds in equal shares to his two children, with the estate taxes chargeable to his residuary estate which passes to his children. If the surviving spouse sells her stock, why should the payment of the deferred tax be accelerated? The children do not have the sales proceeds available to them for payment of the tax.

In theory, acceleration should occur only if the disposition is made by the person or persons charged with the responsibility for the payment of the tax. However, the preparation of an amendment to §6166(g)(1) to avoid the inequitable result in the case discussed in the preceding paragraph is not easy and presents many of the problems that exist in interpreting §303(b)(3). If a relatively simple solution cannot be devised, an approach which, while not ideal, would be preferable to current law is to increase the percentage from one-third or to one-half or more. A 50% figure is now used in §6166A for dispositions or withdrawals.

g. Certain Tax-Free Reorganizations

Acceleration of the deferred tax occurs under §6166(g)(1) if more than one-third of the value of the

closely held business interest is "distributed, sold, exchanged or otherwise disposed of". Section 6166(g)(1)(C) provides that an exchange of stock in some but not all tax-free reorganizations described in §368 is not subject to the acceleration rule. See Treas. Reg. §20.6166-3(e)(2). All reorganizations described in §368 should be exempted from this rule, provided the stock received in the reorganization satisfies the definition of "non-readily-tradeable stock" in §6166(b)(7)(B) or indebtedness is received in a company whose stock is so defined. Such a rule would be consistent with the result under §303 when a tax-free reorganization occurs. See §303(c).

6. Qualification as a Proprietor

Section 6166(b)(1)(A) defines an "interest in a closely held business" to include "an interest as a proprietorship." During the past year, Service personnel have asserted that the activities of a manager or agent will not be imputed to a decedent in determining whether the requirement of §6166(b)(1)(A) has been satisfied. In the self-employment tax area (qualification for social security coverage and liability for tax), courts have held that material participation may occur through agents and employees. Harper v. Flemming, 288 F.2d 61 (4th Cir.

1961); Henderson v. Flemming, 283 F.2d 282 (5th Cir. 1960); Foster v. Celebrezze, 313 F.2d 604 (8th Cir. 1963). See also Rev. Rul. 64-32, 1964-1 Cum. Bull. 319. Prior to the enactment of §6166 (now §6166A) in 1958 the Service acknowledged that material participation in farming could be accomplished through agents. Treas. Reg. §1.1402(a)-1(b)(2); Rev. Rul. 56-22, 1956-1 Cum. Bull. 588. Thus, a reasonable assumption is that Congress intended to permit agency relationships to be used in determining whether a trade or business was involved for purposes of §6166. The fact that in 1974 Congress changed the self-employment tax to exempt farm owners whose material participation in farming was attributable to activities of agents (PL 93-368) should not be interpreted as evidence of a Congressional intent to "read" this change into §6166. Further, such a position would create an undesirable distinction between a sole proprietorship and a partnership or corporation owning a farm. If a partnership or corporate holding is involved, the agency activities would be recognized because §§6166 and 6166A refer to the partnership or corporation carrying on a trade or business.

The legislative history of any changes in §6166 should state the intention of Congress that the activities

of agents and managers shall be taken into account in determining whether the test of §6166(b)(1)(A) is met.

7. Real Estate Holdings

Neither §6166(b)(1) nor the regulations promulgated thereunder contain a definition of the term "trade or business." In 1975, the Revenue Service issued Rev. Rul. 75-365, 1975-2 C.B. 471, which contained the following statement: "[S]ection 6166 was intended to apply only with regard to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of rental property by an owner can never be considered the conduct of a trade or business." Such a restrictive interpretation finds no support in the legislative history accompanying the enactment of §6166, nor is it consistent with any other provision of the Revenue Code. In fact, for purposes of §§346(b) and 355, the management of rental property has been held to satisfy the more stringent "active" conduct of a trade or business test contained in such sections. See, for example, Rev. Rul. 57-334, 1957-2 C.B. 240.

The legislative history of any changes in §6166 should state the intention of Congress that there is no absolute prohibition against the management of rental

property qualifying as a trade or business for purposes of §6166(b)(1). The quality and quantity of activity which should be required in determining the existence of a trade or business in the case of real estate should be the same as for any other enterprise.

8. Husband and Wife Holdings

Section 6166(b)(2)(B) directs that stock or partnership interests which are community property of a husband and wife or are held by husband and wife as joint tenants, tenants by entirety or tenants in common shall be treated as owned by one shareholder or partner. This rule is not applicable to interests owned individually by a husband and wife or their estates. Thus, the form of ownership for a husband and wife may cause a difference in result under §6166. This seems inappropriate, particularly when the interest of one spouse was received from the other spouse through a transfer which is includible in the other spouse's gross estate under §2035. A single rule which treats individual holdings of a husband and wife or their estates as owned by one shareholder or one partner is desirable and consistent with the result for subchapter S corporations under §1371(c). In general we believe a single qualification requirement in terms of the number of

shareholders is desirable for §6166 and subchapter S corporations.

The last sentence of §6166(c), containing a special rule for interests in two or more closely held businesses being treated as an interest in a single closely held business, is the same as §6166(b)(2)(B) and should be modified in the same manner suggested in the preceding paragraph for §6166(b)(2)(B).

9. "Interest in Closely Held Business" Changes

We believe three changes should be made in the definition of an "interest in a closely held business" which would improve the operation of §6166.

a. "Small" Shareholders

Our members have often represented estates of shareholders in a company where no market exists for the shares but neither the voting stock nor shareholder requirement can be satisfied. For example, the decedent may own 3% of the outstanding stock of a company having 50 shareholders. When the value of the stock satisfies the threshold percentage requirement of §6166, deferral should be available. This may be done by expanding the definition of an "interest in a closely held business" to include any stock of a corporation which has no market on a

stock exchange or in an over-the-counter market at the decedent's death. See §6166(b)(7). This would in effect eliminate the requirement that the decedent own 20% of the voting stock of the company in any case where the shareholder number test cannot be satisfied.

b. Partnership Interests

In order for a partnership interest to qualify as an interest in a closely held business the decedent must have at least 20% of the total capital interest if the partnership has more than 15 partners. Partnership profits may be shared in a manner different from the partners' capital interests. Section 6166(b)(1)(B)(i) should be broadened to permit a 20% interest in partnership profits to qualify as an interest in a closely held business. Many provisions of the Code do not distinguish between an interest in capital or profits. See §§318-(a)(2) and (3), 544(a)(1) and (2), 554(a)(1) and (2), 707(6)(1) and (2) and 1563(e)(2).

c. Corporate or Partnership Indebtedness

Corporate or partnership indebtedness owed to a decedent whose stock or partnership interest meets the requirements of an interest in a closely held business is not considered a part of the business in applying §6166.

While a distinction between debt and equity interests may be appropriate for income tax purposes, we believe such a distinction is unwarranted for purposes of §6166 when the decedent has a substantial interest in the company. Further, in the case of a corporation, a distinction between indebtedness and preferred stock seems inappropriate. Indebtedness should be included as part of an interest in a closely held business when the "qualifying" stock or partnership interest (exclusive of the indebtedness) satisfies the threshold percentage qualification requirement.

10. Two or More Interests

A special rule is contained in §6166(c) and §6166A(d) which permits interests in two or more closely held businesses to be treated as a single interest. In order to satisfy this rule, each interest must have a value equal to a stated percentage of the total value of each such business. This percentage is 20 in the case of §6166 and 50 in the case of §6166A. In determining whether the test is met, interests held by members of the decedent's family as defined in section 6166(b)(1) are taken into account. The test is different from the threshold percentage requirement in §6166(b)(1)(B)(i) or

(b)(1)(C)(i) and the corresponding provisions in §6166A. This "dual" test for each interest may cause an interest which alone qualifies for deferral to lose this qualification when combined with another interest. Such a result is undesirable. Further, the 20% test introduces a valuation issue which may not be resolved in the federal estate tax proceeding. Unless the decedent owns 100% of the corporation or partnership, a determination of the value of the entire business will not be made. The special "combination" rule should be changed to use the same tests contained in §6166(b)(1)(B) and (b)(1)(C), namely, that each interest which satisfies the definition of an "interest in a closely held business" will qualify provided the value of all such interests exceed the threshold percentage qualification requirement.

11. "Contemplation of Death" Additions

Treas. Reg. §20.6166-2(c)(1) states

> "it is not necessary that all the assets of the partnership or the corporation be utilized in the carrying on of the trade or business"

Concern has been expressed that this regulation may permit the addition of liquid assets to a partnership or corporation for the purpose of securing a tax deferral with respect to such assets. This concern could be eliminated by

having the legislative history of the §6166 changes approve of a restriction on Treas. Reg. §20.6166-2(c)(1) which would be substantially the same as the limitation in §341(e)(7) stating that a contribution will be ignored "if it appears that there was not a bona fide business purpose for the transaction in respect of which such amount was received."

12. Chapter 13 Tax

Section 2621(b) states that §§6166 and 6166A shall not apply to the Chapter 13 tax imposed on certain generation-skipping transfers. We believe this policy decision is untenable. The Chapter 13 tax is a substitute for an estate tax. In almost all other respects, including the application of §303, the Chapter 13 tax is "conformed" to the estate tax. See §§2602(c) and (d) and 2614. No reason is given in the Chapter 13 legislative history for excluding the application of §§6166 and 6166A.

On the other hand, §303(d) contains a special rule for Chapter 13 transfers which is broad and difficult to justify as a policy matter. If a Chapter 13 transfer occurs at or after the death of the deemed transferor §303 will apply provided the value of the stock included in the transfer equals or exceeds 50% of the value of the

transfer. Thus, if the trustee has a discretionary power to distribute principal after the deemed transferor's death and the transfer does not occur at death, the trustee by selection of particular property to be distributed (the stock) may assure the application of §303(d) because the remaining trust property is not taken into account in applying the 50% qualification test.

The answer lies in applying §6166 to some Chapter 13 transfers and to restrict the application of §303(d) to the same transfers. The "protected" transfers should be taxable terminations occurring at or after the death of the deemed transferor, which is in general the test under §2602(d) for the application of the alternate valuation method to Chapter 13 transfers. Such terminations would include those occurring within three years before the death of the deemed transferor that are covered by §2602(e).

13. Attribution Rules

The Revenue Act of 1978 contained the so-called "Gallo Wine amendment" which applies the family attribution rules of §267(c)(4) in determining eligibility under §6166 in terms of the shareholder or partner number test or the percentage of capital interest or voting stock

requirement. These rules attribute ownership between brothers and sisters but not between spouses of brothers and sisters and descendants of deceased brothers and sisters. As a result, the order of deaths of brothers and sisters may be crucial and the last to die will not have the benefit of attribution which was available to the first to die. Such a result seems unwarranted. Attribution should be permitted from spouses of brothers and sisters and descendants of deceased brothers and sisters.

In addition, attribution should not be lost as a result of the death of a family member. Stated another way, estates of members of a decedent's family should be covered by §6166(b)(2)(D).

14. Section 2032A Property

This section permits certain real property, including farms, to be valued for estate tax purposes in accordance with a special valuation method that produces a value less than its fair market value. The lower value must be used in determining whether the estate qualifies for deferral under §6166 or 6166A. As a result, an estate may be forced to choose between using §2032A and §6166 or 6166A. We believe forcing such a choice is undesirable

and inconsistent with the purposes of these provisions. Section 6166 should be amended to permit all qualified real property, as defined in §2032A(b), to qualify under §6166.

15. Judicial Forum for Resolving Qualification Disputes

Neither §6166 nor §6166A deals with the issue of how a dispute between an estate and the Service concerning whether the estate satisfies the qualification requirements of the section. Revenue Procedure 79-55, IRB 1979-48 at 20, states that if such a dispute arises the estate may request technical advice from the National Office, but if the advice is negative, the estate appears to be without a forum to dispute the determination. A judicial forum should be available to an estate in such a case. We believe this may be accomplished by treating the additional amount of tax claimed by the Service as an asserted estate tax deficiency.

16. Unfunded Bequests

At death, a decedent may be entitled to receive property from an estate or trust which _may_ include an interest in a closely-held business. For example, a husband could die owning such an interest and leave his surviving spouse by will a pecuniary bequest in an amount equal to

the maximum marital deduction and the wife could die shortly after her husband and prior to the funding of the marital deduction bequest. In such a case, the determination of whether the wife's estate includes an interest in a closely-held business depends upon whether the executor of the husband's will distributes the interest in satisfaction of the marital bequest. The wife's estate should be entitled to treat such interest as included in the estate for purposes of applying §6166 to the extent that the interest is distributed to the estate. In determining the amount of the deferred tax, the interest would be valued as if it were included in the decedent's gross estate.

E. Suggested Changes in Related Provisions

1. Alternative Minimum Tax

If a taxpayer's adjusted itemized deductions, as defined in §57(b), exceed 60% of his adjusted gross income, the excess is treated as a tax preference and subject to the alternative minimum tax imposed by §55. Thus, to the extent that interest on deferred estate tax is claimed as an income tax deduction, an alternative minimum tax "problem" may exist. The application of this tax to interest on any death tax is inappropriate and inconsistent with the policy behind §§6166 and 6166A. The

alternative minimum tax should be modified to eliminate interest on any death tax as an adjusted itemized deduction. Consideration should also be given to eliminating interest on any tax as an adjusted itemized deduction. We have never heard or seen a satisfactory explanation as to why such interest should enter into the computation of the alternative minimum tax.

2. Section 303

This provision provides a safe haven from dividend treatment for the redemption of stock in an amount equal to the decedent's death taxes and interest thereon, funeral expenses and "allowable" administration expenses under §2053. A literal reading would permit "double dipping" in the sense that the interest on death taxes could be claimed twice, once as interest under §303(a)(1) and again as an administration expense under §303(a)(2). The section should be revised to prevent this result. The question then arises as to whether the §303 amount should reflect interest on death taxes and, if so, how the problem of the redemption occurring prior to the payment of future interest should be handled.

Under current law, §303 could apply when the decedent's estate is not eligible for deferral under §6166

or 6166A with respect to the estate tax attributable to the asset being redeemed. This could occur because (1) the threshold percentage requirement is higher under the deferral provisions than under §303 or (2) the asset does not qualify under §6166 or 6166A but does qualify under §303. As to (1), the threshold percentage requirement suggested in part D above would eliminate the disparity. As to (2), a policy decision is required concerning whether §303's broader coverage should be continued. We believe it should be. The redemption may occur before the §303 amount has been finally determined. If the redemption occurs and its amount plus all prior redemption amounts as to which §303 protection is asserted exceeds the protected amount already paid, the shareholder should be required to file the "final" figures with the Service and waive the application of the statute of limitations for a stated period after these figures are so supplied.

Another simplification could be achieved by modifying the aggregation rule of §303(b)(2)(B) to conform with the aggregation rule of §6166(c), which should be revised in the manner suggested above.

Finally, "conforming" changes to proposed §6166 should be made in §303(a)(2) and (b)(2)(A)(ii) to exclude

post-death interest in determining the amounts "allowable" as deductions under §2053.

3. Sections 302 and 318

Closely-held stock included in a decedent's gross estate may fail to qualify under §303. In such a case, §302(b)(3) permits a redemption to be treated as an exchange (capital gain) if it is in "complete redemption of all the stock of the corporation owned by the shareholder." The constructive ownership rules of §318(a) are applicable in determining whether a complete redemption has occurred. Section 318(a)(3) provides that stock directly or indirectly owned by a beneficiary of an estate or trust is deemed owned by the estate or trust. The Tax Court has held in two cases that an estate or trust may file an agreement under §302(c)(2) waiving family attribution, with the result that a waiver by the estate or trust and a beneficiary prevents attribution to the estate or trust through the beneficiary. Lillian M. Crawford, 59 T.C. 830 (1973); Rodgers P. Johnson Trust, 71 T.C. 941 (1979). These decisions should be "codified" by amending §302(c)(2) to refer specifically to an estate or trust as a "distributee".

4. Section 2011 Credit

As previously noted, some states permit the

payment of a state death tax attributable to a closely-held business to be deferred and paid in installments. The usefulness of these statutes has been lessened by the Service's policy regarding allowance of the state death tax credit authorized by §2011. The Service has taken the position that a credit under this section will be allowed only to the extent a state death tax has been paid at the time of the allowance. See Gibbs, Emerging IRS Attitude Toward State Death Tax Credit and Its Impact on Installment Payment of Estate Taxes, U. Miami 14th Inst. on Est. Plan. ¶1800 (1980). §2011 credit should also be allowed for deferred tax provided the executor certifies that a state death tax in an amount at least equal to the credit will be paid.

Senator BYRD. Next is a panel of five: Ruth Kobell, legislative assistant, National Farmers Union; Bill Jones, vice president, National Cattlemen's Association; Grace Ellen Rice, assistant director, National Affairs Division, American Farm Bureau Federation; Stevan A. Wolf, government affairs chairman, National Family Business Council; John Lavine, Chippewa Falls, Wis.

Welcome, and you may proceed as you wish.

STATEMENT OF RUTH E. KOBELL, LEGISLATIVE ASSISTANT, NATIONAL FARMERS UNION

Ms. KOBELL. Thank you, Mr. Chairman.

You have a long list of witnesses this morning, and we have been asked to be brief.

I am Ruth Kobell, legislative assistant for the National Farmers Union.

The operation of a family farm has and continues to involve all members of a family in a large majority of cases. From the days when immigrants were drawn to our Nation with the hope of free land on which to farm and to establish their families, it has been expected that the farms would pass from one generation to the next.

As the wave of settlements moved west across our Nation and the Homestead Act of 1861 made possible a vesting of ownership in a large number of families, the family farm has provided an abundant and stable food supply, a stable pattern of family life, and a concern for conservation and improvement of soil and water under the direction of a farm family.

Since the turn of the century we have seen a reversal in the pattern of rural settlement in this country. The size of farms has

increased and the number of farms has decreased. The mechanization of farming and ranching, the introduction of electric power and telephone service to remote rural areas, and the energy and advanced technical skills and management of America's family farms have provided increasing productivity which is the envy of many other branches of industry here and abroad.

Let me say, in passing, that this has not resulted necessarily in an increase in farm income, as is all too evident now. Our parity index stands close to the lowest it did in the Great Depression.

The increasing size and mechanization of our farms, coupled with a spiraling inflation in both real estate and property values, has radically altered the ability of many farm families to pass the farm on to the next generation. You had considerable technical detail this morning as to the problems involved.

We appreciate your recognition of the continued pressures of inflation on farm expenses, as well as property values. S. 2967 would increase the amount of property that may pass free of Federal estate and gift taxes from the present $175,000 to about $500,000. It also doubles the amount of property which an individual can give tax free annually to another individual from $3,000 to $6,000.

Such improvements were part of recommendations made by delegates to the National Farmers Union Convention meeting in Denver, Colo., in March of this year. I have included an excerpt of that policy statement in my testimony, and it is available for your review.

The issue of the contribution of both men and women in most family farm operations which is addressed in the last paragraph of our policy statement is clearly addressed in S. 2067. This very important provision exempts from estate and gift taxes all property inherited or transferred to a spouse.

Under Senator Nelson's leadership, the initial step regarding a tax exemption for the working contribution of surviving spouses was enacted in the Revenue Act of 1978. This area of tax law is of great concern to farm women here and around the world.

A majority of the farmers of the world are women. They provide a major amount of the labor, management, and marketing know-how for production of food and fiber for their own families and other members of their society. In all too many cases, they have not shared equitably in land ownership or inheritance upon death of their spouse.

Since women have a longer average lifespan than men, this becomes an extremely important policy direction. Women in such nations as Canada and Australia are moving aggressively to address this problem through legislative action.

S. 2967 would, of course, write into Federal law the recognition of the working contribution of the farm women in America. This would go a long way to assisting in the continuation of family farm agriculture in this country, and we pledge our efforts to work for enactment.

We notice the final regulations of IRS relating to estate and gift taxes were published very shortly before this hearing. We would be anxious that the committee staff review carefully any ways in which those regulations would relate to the outlines of this legislation.

We appreciate the opportunity to appear, and we will be glad to try and answer any questions.

Senator BYRD. Thank you, Ms. Kobell.

[The prepared statement of Ms. Kobell follows:]

STATEMENT OF
RUTH E. KOBELL
LEGISLATIVE ASSISTANT
NATIONAL FARMERS UNION

TO

COMMITTEE ON FINANCE, SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE

REGARDING

S. 2967
FAMILY ENTERPRISE ESTATE TAX EQUITY ACT

AUGUST 4, 1980

Dear Mr. Chairman:

I am Ruth E. Kobell, Legislative Assistant for National Farmers Union, 1012 - 14th Street, N.W., Washington, D. C. The legislation which is the subject of your hearing today, S. 2967, the "Family Enterprise Estate and Gift Tax Equity Act" is of major interest to the 300,000 farm family members of National Farmers Union. We appreciate this opportunity to comment.

Operation of a family farm has and continues to involve all members of the family in the large majority of cases. From the days when immigrants were drawn to our nation with the hope of free land on which to farm and to establish their families, it has been expected that the farms would pass from one generation to the next. As the wave of settlements moved West across our nation and the Homestead Act of 1862 made possible a vesting of ownership in a large number of families, the family farm has provided abundant and stable food supply, a stable pattern of community life, and a concern for conservation and improvement of soil and water under the direction of the farm family.

Since the turn of the century, we have seen a reversal in the pattern of rural settlement in this country. The size of farms have increased and the number of farms have decreased. The mechanization of farming and ranching, the introduction

of electric power and telephone service to remote rural areas, and the energy and advanced technical skills and management of America's family farms have provided increasing productivity that is the envy of many other branches of industry here and abroad.

The increasing size and mechanization of our farms, coupled with a spiraling inflation in both real estate and property values, has radically altered the ability of many farm families to pass the farm on to the next generation.

We appreciate the concern and leadership of Congress in the successful enactment in 1978 of legislation which raised the exemptions from estate taxes on family farms and closely held businesses, and instituted a unified tax credit which in 1979 was equivalent to an exemption of $175,000.

We appreciate the recognition of the continued pressures of inflation on farm expenses as well as farm property values. S. 2967 would increase the amount of property that may pass free of federal estate and gift taxes from the present $175,000 to $500,000.

It also doubles the amount of property which an individual may give tax-free annually to another individual from $3,000 to $6,000.

Such improvements were part of recommendations made by delegates to the National Farmers Union convention meeting in Denver, Colorado, March 1980. Following is an excerpt from that policy statement relating to estate taxes.

> "We urge the Congress to continue and further strengthen those provisions of the Tax Reform Act of 1976 that were favorable to family farmers, specifically, (1) the federal farm-use valuation provision embodied in Section 2032 A of the Internal Revenue Code (IRC) and (2) the 15-year installment payment provision for estate taxes found in Section 6166 (IRC).
>
> "In regard to these sections, we believe that the special lien and tax recapture features of these provisions cause great uncertainties by potentially keeping estates open for a long period of time with undue burdens and costs in estate administration, and by causing other potential liability problems for heirs when the estate is not so prolonged. Congress should amend these sections to avoid such problems.

"Congress should increase the maximum unified tax credit to the equivalent of a $300,000 exemption, and increase the annual gift tax exclusion to $6,000.

"A husband and wife should be considered equal owners of a farm or small business if they so designate, so that it should not be necessary for the spouse to prove contribution to jointly owned property. Joint tenancies should be recognized as being owned half by each."

The issue of the contribution of both women and men in most family farm operations, which is addressed in the last paragraph of our policy statement is clearly addressed in S. 2067. This very important provision exempts from estate and gift taxes all property inherited or transferred to a spouse. Under Senator Nelson's leadership, the initial step regarding a tax exemption for the working contribution of surviving spouses was enacted in the Revenue Act of 1978. This area of tax law is of great concern to farm women here and around the world.

A majority of the farmers of the world are women. They provide a major amount of the labor, management, and marketing know how for production of food and fiber for their own families and other members of their society. In all too many cases, they have not shared equitably in land ownership or inheritance upon death of their spouse. Since women have a longer average life span than men, this becomes an extremely important policy direction. Women in such nations as Canada and Australia are moving aggressively to address thie problem through legislative action.

S. 2967 would, of course, write into Federal law the recognition of the working contribution of farm women on American farms. This would go a long way to assisting in the continuation of family farm agriculture in this country and we pledge our efforts in urging speedy enactment.

We recognize that decisions of the Courts, rulings by the Internal Revenue Service and various state laws also relate to estate settlement. But, we believe that such forthright direction from the Congress, recognizing the importance of a working spouse in a family enterprise by providing for an unlimited marital deduction, will give strong and important support for the long-deserved recognition of equality between spouses.

This legislation, of course, also adresses other special concerns that are of importance to America's farmers. The simplification of the "special evaluation" rule takes into consideration the problems of elderly spouses, those receiving

old age benefits, those who are disabled, minors and students who might be heirs to the family farm. The present law requires an heir to actively work on the farm for 15 years following the death of the decedent in order to qualify for the special use valuation of the land. Clearly an heir who is an elderly spouse, disabled, a minor or a student might not be able to comply with this and thus have to pay the additional tax based on the higher value. We are happy to see that the bill would allow the heirs to hire someone to work on the property for them for 10 years and still qualify for the special use valuation. We note that the requirement to actively work the farm for 15 years is being changed overall to a 10-year period, which in many cases is certainly long enough to prove the intent of keeping the land in farming.

We note that the Department of the Treasury, Internal Revenue Service issued final regulations on July 31, 1980 relating to Income and Estate and Gift Taxes, Certain Farm Real Property. I have not had an opportunity to seek an analysis on ways in which these regulations would relate to the proposals made in S. 2967, or to farmers' rights and responsibilities under Social Security law and regulations. I hope that your Committee staff will be able to review these regulations in detail so that if regulations weaken the thrust of this legislation, it can be appropriately addressed.

I believe we should reiterate that the steps outlined to improve and update estate tax legislation not only serves to keep farm families on the land, but would be a major step to assuring the continuation of family farm agriculture as the most efficient and productive mode of assuring an abundant and stable supply of food and fiber for the citizens of our nation and for the important export business that so helps with the balance of trade.

The President's Commission on World Hunger and other studies point to the increasing importance of protecting our farm production and I believe this makes an important contribution to that end.

We appreciate the opportunity to present this testimony and will be anxious to support the legislation as it moves through the Congress.

Senator BYRD. Mr. Jones, we will hear from you now.

STATEMENT OF B. H. JONES, VICE PRESIDENT, NATIONAL CATTLEMEN'S ASSOCIATION

Mr. JONES. Thank you, Senator Byrd, and other members of the committee.

My name is B. H. Jones, the National Cattlemen's Association. The subcommittee is familiar with this organization, so I will not go into the details with respect to our membership and so forth.

On S. 2967, the National Cattlemen's Association commends the sponsors of S. 2967, first of all, for recognizing the urgent need to make changes in the existing statute and then for turning such recognition into action by developing and introducing comprehensive amendments to the present as affects farmers and ranchers, and other closely held businesses.

The association strongly supports the provisions of S. 2967 to increase the unified credit; to provide for an unlimited marital deduction; to increase the annual gift exclusion; and to solve the

problems that have arisen in the practical implementation of the special use valuation formula, this, of course, is section 2032A of the Tax Code.

Now, Mr. Chairman, in view of the time, we would ask that the complete statement be given consideration, but I would just like to comment on about a half-dozen technical amendments that we would suggest.

First of all, let me comment on the unlimited marital deduction comments that Treasury and the former witness have stated. We see absolutely no problem with this provision as long as it is made elective. In fact, any problem that they have brought up would be solved by making it elective, and we think that, by all means, the heirs and the spouses ought to be given this privilege.

We hope that those comments that have been made will not dampen the enthusiasm of the subcommittee to move ahead with the unlimited marital deduction. We generally had good consensus, I think almost total consensus among the Senators, and also among witnesses prior to today. Making that an election, rather than mandatory, we see absolutely no problem with it.

We would suggest a technical amendment in the active management portion. We think that just the word "the" ought to be dropped from the definition to make it clear that not every management decision has to be made in order for there to be active management qualification.

Also on the tax free exchanges, this is treated on the postdeath side, but is not treated on the predeath. We would suggest that the same provision that is made for the tax-free exchange of property on the postdeath side be also made on the predeath.

On the special use valuation formula, we certainly commend the staff and the committee for recognizing this problem, and the effort that has been taken to solve it in the bill. It is a unique approach in using cash rentals, and that we support very, very strongly.

We think that there may be some problem in obtaining the data upon which this would be based, and so we have, again, repeated the recommendation we made before the subcommittee previously that a different approach be used, and we have attached suggested legislative language as appendix A to our statement which we think would be somewhat of a better approach.

Split gift pullback, we think that this ought to be included along with the increase in the annual exclusion, and note that it has not been included in this draft bill.

Also, in following up on the former witnesses' statement with regard to the effective dates, we recognize the pressure here, the budget pressures of phasing in such things as a unified credit increase. However, especially in the case of crop shares and the ability to use crop shares, this is of immediate urgency and we would recommend that this particularly be made retroactive to those dying after December 31, 1976.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Mr. Jones.

[The prepared statement of Mr. Jones follows:]

S T A T E M E N T

of the

NATIONAL CATTLEMEN'S ASSOCIATION

to the

Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

Relative to S. 2967 - Family Enterprise Estate and Gift Tax Equity Act

Presented by
B. H. Jones, Vice President
National Cattlemen's Association

August 4, 1980

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry--including cattle breeders, producers, and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 15 affiliated national breed organizations.

S U M M A R Y   O F   S T A T E M E N T

on

S. 2967 - Family Enterprise Estate and Gift Tax Equity Act

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The National Cattlemen's Association commends the sponsors of S. 2967, first of all, for recognizing the urgent need to make changes in the existing estate and gift tax provisions and, then, for turning such recognition into action by developing and introducing comprehensive amendments to the present law as it affects farmers and ranchers and other closely held businesses.

The Association strongly supports the provisions of S. 2967 to increase the Unified Credit, to provide for an Unlimited Marital Deduction, to increase the Annual Gift Tax Exclusion, and to solve the problems which have arisen in the practical implementation of the Special Use Valuation provision (Section 2032A of the Internal Revenue Code).

With respect to the latter, the bill drafters have given special attention to the problems associated with the Material Participation requirements as they bear on retired farmers and ranchers and on surviving spouses and other qualified heirs. The NCA supports the proposed changes contained in the bill which address both pre-death and post-death participation.

The Association also favors reducing the Recapture period from 15 years to 10 years; the repeal of the $500,000 Limitation; and the provision for Tax-Free Exchanges of farm-use-valued property by qualified heirs, but does suggest that a similar pre-death provision be included in the bill. In addition, the NCA supports the repeal of present Involuntary Conversion Election Requirements.

S. 2967 recognizes the major problem which has developed in the farm use valuation provision in finding comparable properties on which there are cash rentals. The bill addresses the problem by providing for the use of crop share rentals and by inserting the word "reasonably" (comparable). This is an innovative approach and it is obvious that the sponsors and committee staff have given a great deal of attention to coming

up with a solution to the problems which have developed in the country over the rental and comparability questions.

In this connection, the NCA has made inquiry as to the availability of published data upon which crop share rentals would be determined under the bill. Since such inquiry leads to the conclusion that said data is not readily available, and, furthermore, that comparability continues to be a major problem, the Association repeats the suggestions made in its testimony to the Subcommittee on March 4 and 24 of this year to eliminate comparability entirely and to provide for the land to be valued on the basis of the rental of the property in question. Legislative draft language for such an approach is attached as Exhibit A.

In commenting further on the farm use valuation changes contained in the bill, the NCA favors adding the Recapture Tax to the basis of the property, and basing the value of property gifted within three years of death upon its value at the gifting date. The Association does suggest that provision be made wherein "split gifts" would not be subject to the three year pullback or inclusion rule as long as said gifts do not exceed the combined annual exclusions of husband and wife.

The NCA endorses combining the 10-year and the 15-year Installment Payment provisions and the liberalization called for in the proposed legislation. The Association also favors the amendment made to the Disclaimer Rule.

The NCA recognizes the existing budget pressures to phase in such changes as the increase in the Unified Credit; however, in the case of modifications to the Farm Use Valuation provision, these should apply as soon as possible and the Crop Share amendment should be made retroactive to cover decedents who have died since December 31, 1976.

STATEMENT

The National Cattlemen's Association ("NCA") commends Senators Nelson, Byrd of Virginia, Wallop and Eagleton for their introduction and sponsorship of S. 2967 (Family Enterprise Estate and Gift Tax Equity Act) and for their demonstrated concern with, and interest in solving estate and gift tax problems faced by owners of family operated farms, ranches and other closely held businesses. The need to provide for and encourage the continued operation of family owned farms, ranches and other businesses without the disruption often caused by federal estate taxes is essential to the viability of these businesses and is of great importance to our nation's well being.

S. 2967, if enacted, would take a monumental step in preventing the untimely and forced liquidation of family operated farms, ranches and other closely held businesses caused by federal estate taxes and would achieve needed equity in the estate and gift tax area by bridging certain gaps which were created in the 1976 Tax Reform Act and the 1978 Revenue Act, as well as by responding to problems raised as a result of interpretations given to various estate and gift tax provisions by the Treasury and IRS.

On March 24 of this year, NCA appeared before this Subcommittee and presented testimony regarding S. 1984, S. 1825 and S. 2220. NCA appreciates the opportunity afforded it, following this testimony, to submit materials and make comments to the Subcommittee with regard to these bills and to

offer certain technical suggestions for consideration. S. 2967 addresses most of the issues which were highlighted by NCA in its March 24 testimony, as well as problems which have developed in compliance with, and interpretation of, the estate and gift tax laws affecting estates of farmers, ranchers and other business owners.

NCA strongly supports the concepts contained in S. 2967 and applauds the Subcommittee for its work on this bill and for its initiative in holding hearings at this time so that this important legislation can move forward at an accelerated pace.

Increase in Unified Credit

Under S. 2967, the unified credit, which under present law becomes $47,000 in 1981, would be increased to $155,800, with such increase to be phased in over a number of years. The $155,800 credit translates into $500,000 in value of property which could be transferred without the imposition of gift or estate tax. In light of double digit inflation, the $47,000 credit enacted in the 1976 Tax Reform Act is totally inadequate and should be significantly increased. The credit of $155,800 is a proper amount and NCA supports this increase in the unified credit. Such increase would help reduce the estate tax burden on farm and ranch estates and would have the beneficial effect of fostering the transfer of farms and ranches to family members. To the extent the estate tax burden is lessened, this will mean there is a greater likelihood that family farms and ranches

will be able to continue in operation without forced liquidations as a result of estate taxes.

Unlimited Marital Deduction

The transfer of property between spouses is not an appropriate time for a gift or estate tax to be imposed. S. 2967 recognizes this principle by providing that no gift or estate tax will be imposed upon transfers of property between spouses. This rule would apply whether spouses live in common law states or community property states. NCA strongly supports this unlimited marital deduction and feels it would be most beneficial in all situations, but particularly, with respect to transfers of farms and ranches between spouses either during lifetime or at death. Additionally, this provision would eliminate much of the complexity which exists under present law in cases where the IRS contends that the current $100,000 marital deduction applies only once even though a person may be married a number of times and where the current estate tax marital deduction is reduced by virtue of gifts of less than $200,000 made during lifetime between spouses.

The unlimited marital deduction would also help eliminate many of the problems concerning contribution by a surviving spouse to jointly held property and the attendant costs and expenses involved, as well as problems relating to potential gift tax liability where jointly held property used in a farming or ranching business is placed in co-tenancy or in a family partnership during lifetime.

Increase In Annual Gift Tax Exclusion

The present annual gift tax exclusion of $3,000 would be increased to $6,000 under S. 2967. The $3,000 annual exclusion has been in the law since the 1940's and NCA feels a substantial increase in the annual exclusion is long overdue. Based upon cumulative inflation since 1940, the $3,000 annual exclusion should be in excess of $16,000. As the first step in modifying the current annual exclusion of $3,000, NCA strongly endorses increasing it to $6,000, but would observe that an even larger amount, based upon inflation, could be justified.

Valuation Of Certain Farm And Other Real Property

S. 2967 would make a number of beneficial amendments to the farm use valuation provision (Section 2032A of the Internal Revenue Code) which was added by the 1976 Tax Reform Act. NCA feels these amendments will make Section 2032A more responsive to the stated Congressional purpose of encouraging the continued use of property for farming by members of the deceased farmer's family.

A. Special Rule for Retired and Disabled Decedents

Under the present provisions of the farm use valuation rule, a deceased farmer or members of his family must have materially participated in the farm or ranch operation during five out of the eight years prior to date of farmer's death in order to have the farm property qualify for the farm use valuation election. Significant problems have developed since 1976 as a result of this material

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participation rule. One of the most severe is that retired farmers and ranchers face the prospect of having their Social Security benefits either reduced or eliminated if they materially participate in the farm business; but the farm use valuation provision will not be available to their estates if they do not materially participate in the farm operation. S. 2967 directly addresses this problem by permitting the deceased farmer's or rancher's estate to qualify for the farm use valuation provision if the farmer would have met the 5 out of 8 year material participation test during the 8 year period prior to his becoming eligible to receive Social Security benefits or prior to the time he was disabled. This would allow farmers who retire and are eligible to receive Social Security benefits the alternative of receiving Social Security benefits and not materially participating in the business, if they satisfied the material participation test prior to becoming eligible to receive such benefits.

A special rule would also be applied in the case of surviving spouses who were qualified heirs. Such spouses would be permitted, under S. 2967, to have their estates qualify for the farm use valuation election if they were involved in the active management of the farm business at all times during a 10-year period ending on the date of their death or during the period from their spouse's date of death to their date of death. This provision addresses the problem of a widow or widower who inherits a farm or

ranch and because of age or other infirmity is not able to materially participate in the operation, but can take part in the business by making management decisions. While providing the important benefits of the farm use valuation provision to surviving spouses, this rule would retain the protection afforded by the active management standard.

NCA commends the sponsors of S. 2967 for their careful attention to these two serious problems and fully supports the manner in which the bill resolves these problems.

NCA would offer for consideration one minor technical amendment to the provision concerning active management by the surviving spouse. This would involve substituting the words "taking part" for "engaged". This minor technical amendment would provide consistency with the definition of active management which appears in S. 2967 and would permit a surviving spouse, by taking part in the active management of the farm business during the required period of time, to place such spouse's estate in a position to elect farm use valuation if other requirements were satisfied.

B. Dispositions and Failure to Use for Qualified Use

Under the provisions of S. 2967, the present 15-year recapture period following a decedent's death would be decreased to 10 years. The Congressional purpose for the recapture provision in the first instance was to assure that the surviving family members used the farm land for agricultural purposes for a reasonable period of time after the decedent's death. As stated in previous testimony to this Subcommittee,

NCA feels that the 15-year recapture period under current law is excessive and is not needed to deter speculation or assure retention in the family of the farm or ranch land and continuation of the family operation. The 10-year recapture period of S. 2967 is fully supported by NCA and would be a beneficial amendment.

Significant modifications would also be made by S. 2967 to the material participation requirements governing qualified heirs who inherit farm use valuation property. These amendments would permit fiduciaries or the qualified heirs to continue the farm or ranch operation without triggering imposition of the recapture tax if they take part in the active management of the farm or ranch operation for the required 10-year period. These changes are essential to reflect the fact that some surviving family members will not be able to materially participate in the farm business, but will be able to take part in the active management of the farm or ranch by making management decisions.

NCA compliments the sponsors of S. 2967 for their thoughtful approach in solving this post-death material participation problem and endorses this solution to the problem.

NCA would offer for consideration one minor technical amendment to the definition of the term "active management" to eliminate the word "the" before the words "management decisions of a business". This would make it clear that not <u>every</u> management decision would have to be made in order to be deemed to have taken part in the active management

of the farm or ranch business.

C. Repeal of $500,000 Limitation

Under current law, the farm use valuation provision cannot reduce the fair market value of farm or ranch land by more than $500,000. The imposition of the $500,000 limitation significantly limits the benefits of the farm use valuation provision. Moreover, it would appear that the IRS views the $500,000 limitation to be reduced to $250,000 in the case of community property.

S. 2967 would repeal the $500,000 limitation. NCA strongly supports the elimination of the $500,000 limitation, based upon inflation and the increasing values of farm land. Moreover, the $500,000 limitation serves no useful purpose and is, in fact, detrimental to estates of deceased farmers and ranchers.

D. Exchange of Qualified Real Property

A solution is provided by S. 2967 to the problem currently caused by qualified heirs entering into a tax-free exchange of farm-use-valued property for other farm property which they continue to use in the farming or ranching operation. Under present law, such an exchange would result in the imposition of a recapture tax unless the exchange occurred with another family member. Since economic factors and climactic conditions frequently make tax-free exchanges of farm and ranch land with non-family members advisable, there is justification for providing, as S. 2967 does, for exchanges with non-family members. NCA endorses this provision of S. 2967.

NCA observes that no provision appears in S. 2967 regarding tax-free exchanges and involuntary conversions of farm or ranch land prior to a farmer's or rancher's death. Recently, the IRS ruled that where a farmer, within five years prior to his date of death, exchanged farm land for other farm land, the exchanged farm land received and used for farming purposes did not qualify for farm use valuation because this specific land had not been owned and used by the farmer in his farming operation for 5 out of 8 years prior to his date of death. This is an unfortunate result and, accordingly, NCA requests that the Subcommittee consider adding a provision to S. 2967 which would provide that farm land received by a farmer in a pre-death, tax-free exchange, or farm land purchased with the proceeds from an involuntary conversion of farm land prior to the farmer's death, would qualify for farm use valuation even though the property received in the exchange or purchased with the involuntary conversion proceeds has not been held and used for farming for 5 out of the 8 years prior to the farmer's death.

E. Repeal of Election Requirements in Involuntary Conversions

A needed change in current law would be made by S. 2967 by eliminating the election required in the event of an involuntary conversion of qualified property when the surviving family members purchase other farm property for use in the farming or ranching operation. NCA supports this provision.

F. Use of Crop Share Rentals in Rental Valuation Formula

In testimony presented to this Subcommittee on March 4, 1980 and on March 24, 1980, NCA stated that qualified real property should be eligible for farm use valuation under the rental reduction formula even if cash rentals on comparable property were not available. Interpretations by Treasury of the farm use valuation provision is that if there is no cash rental on comparable land, the rental valuation formula is not available. This means the five factor valuation test, with its attendant uncertainties, would have to be used. NCA stated in its previous testimony that permitting crop shares to be used in the rental valuation formula is in keeping with and fosters the original intent of Congress.

S. 2967 addresses the problem created by Treasury's interpretation that crop share rentals cannot be used in the rental valuation formula by providing that crop share rentals may be used where cash rentals from comparable property are not available. S. 2967 takes an innovative approach by providing that the crop share rental is rental from reasonably comparable land determined by reference to information published by the Department of Agriculture, by an agency of the State in which the land is located or by a college or university of the State. If such published information is not available, then the crop share rental is to be calculated on the basis of comparable land located in the locality of the farm. This approach recognizes that the

major problem which has developed in the farm use valuation provision is finding comparable properties on which there is a cash rental.

Since testifying before this Subcommittee in March, NCA has received reports from persons throughout the country indicating that the comparability issue is a big stumbling block. In some states, IRS agents have interpreted comparable to mean "identical in nature". In at least one state, IRS agents have required three leases on comparable land for the full five years prior to a farmer's or rancher's death with the result that many estates have not been able to satisfy this requirement. In this same state, IRS agents have taken the position that only land within a county will be considered as being comparable. Information received by NCA from throughout the country indicates that countless hours are spent and unnecessary costs incurred in trying to "find comparables". This impacts not only on the estates of deceased farmers and ranchers but, also, on effective administration of this provision by the IRS.

Recognition of this comparability problem is clearly reflected in the crop share provision of S. 2967. To determine if there were any potential problems in the S. 2967 approach to remedy the comparability issue, NCA made an informal survey of various state and governmental officials to ascertain if there were published information available on which the rental valuation formula could be calculated under the language of S. 2967. Reports received by NCA

indicate that such information is not available. This means that the existing comparability standard would still apply and if IRS agents continue, as they have in some parts of the country, to take an overly restrictive interpretation of what is "comparable", the rental valuation formula will not be available in areas of the country where there are few, if any, cash rentals on agricultural land.

A simple solution to the comparability issue, which NCA recommends the Subcommittee consider, would be to eliminate comparability entirely and, instead, follow the approach that the qualified real property of a farmer's or rancher's estate be valued based upon the gross rental such property would produce if leased to an unrelated third party on an arm's length basis. A copy of such proposal is attached as Exhibit A. NCA feels that this proposal would add simplicity and continuity to the rental valuation formula and would alleviate most, if not all, of the problems presently encountered on the comparability issue.

G. Recapture Tax Added to Basis of Property

If a recapture event occurs under present law, the amount of the recapture tax is not added to the income tax basis of the property. In testimony previously presented to this Subcommittee, NCA suggested that it was appropriate that any recapture tax be added to the basis of the property for income tax purposes.

S. 2967 provides that the amount of the recapture tax will be added to the income tax basis of the property

which is subject to recapture. NCA strongly supports this provision.

Estate Tax Treatment of Transfers
Made Within Three Years of Decedent's Death

Present law states that the gross estate of a decedent will include gifts made within three years of the decedent's death at date-of-death values. Problems in administration and compliance have been created by this provision in arriving at the amount to be included in the decedent's estate where a gift has been made within three years of the decedent's death. Simplicity would be achieved by the provision in S. 2967 which says that the value of property gifted within three years of date of death would be included in the decedent's estate based upon the value of the property at the time of the gift, rather than at the time of the decedent's death. NCA endorses this provision.

In view of the increase in the annual exclusion from $3,000 to $6,000 under S. 2967, NCA would suggest to the Subcommittee that it consider including an additional provision whereby gifts made by a husband and wife, which are considered "split-gifts", would not be subject to the three year pull-back or inclusion rule if the value of the gift at the time it was made did not exceed the combined annual exclusions of both husband and wife. Such a provision would be extremely beneficial to farmers and ranchers and would encourage gift programs involving younger members of the family so that the farm and ranch operation could be continued.

Election to Pay Gift Tax

NCA supports the provision contained in S. 2967 which would permit a donor making a gift during lifetime to elect whether to pay gift tax or to have the unified credit apply to the taxable portion of the gift.

Coordination of Extensions of Time For Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business

In previous testimony before this Subcommittee, NCA has urged that the 15-year installment payment of estate tax provision and the 10-year installment provision be combined into a single provision and that the requirement for qualification of a closely held business to pay estate taxes in installments be liberalized. S. 2967 has combined the 15-year and 10-year installment payment provisions in an effective and beneficial manner. NCA endorses this new liberalized 15-year provision for paying estate taxes in installments and feels such provision will be of significant benefit to estates of farmers, ranchers and other closely held businesses. Such a provision will also bring about simplicity in both administration and compliance with the installment payment election.

The only comment NCA would offer for the Subcommittee's deliberation would be with respect to the 4% interest rate which applies under current law to the tax on the first one million dollars in value of an interest in a closely held business where a 15-year election has been made. NCA would urge consideration of applying the 4% interest rate to the tax on the entire value of the farm, ranch or other closely

held business which meets the requirements of the 15-year installment payment provision.

Disclaimers

S. 2967 would amend the disclaimer rule with respect to disclaimers which were ineffective under State law. NCA supports this amendment to the disclaimer provision.

Effective Dates

While a number of the provisions of S. 2967 would apply beginning in 1981, some of them would not be effective until 1982. Because of the impact inflation has had, plus the effect of increasing land values, farm and ranch estates would receive needed and immediate benefit if all effective dates were moved up to 1980 or 1981. In the case of the modifications to the farm use valuation provision, these should apply as soon as possible, and the one concerning the use of crop shares should be made retroactive to cover decedents who have died since December 31, 1976.

CONCLUSION

NCA applauds the support given by Senators Nelson, Byrd of Virginia, Wallop and Eagleton in introducing and sponsoring S. 2967. The Association strongly supports the concepts contained in S. 2967 and would respectfully recommend to the Subcommittee that it consider the few amendments which have been suggested and which NCA feels conform to, and foster, the purpose and intent of this bill. As it has in the past, NCA offers to work with the staff of the Subcommittee in the consideration of amendments to S. 2967. Hopefully, the bill will soon be enacted into law to provide equitable and remedial relief to family farms, ranches and other closely held businesses and preserve and encourage their continued operation.

EXHIBIT A

A BILL

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

Paragraph (7) of Section 2032A(e) of the Internal Revenue Code of 1954 is amended to read as follows:

"(7) METHOD OF VALUING FARMS -

(A) IN GENERAL - Unless the executor elects to have the value of the farm for farming purposes determined under paragraph (8), the value of a farm for farming purposes shall be determined by dividing -

(i) the excess of the amount of the average annual gross rental value of the qualified real property used for farming purposes over the amount of the average annual State and local real estate taxes for such qualified real property, by

(ii) the average annual effective interest rate for all new Federal Land Bank loans.

For purposes of the preceeding sentence, each average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.

(B) APPLICATION - The formula provided by subparagraph (A) shall be applicable regardless of whether the qualified real property or any portion thereof has in fact been rented or whether such qualified real property has been rented on a cash, crop shares, or other basis."

Senator BYRD. Ms. Rice, if you will proceed.

STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION

Ms. RICE. Thank you, Senator Byrd.

I am here today on behalf of the American Farm Bureau Federation. We have testified both before this subcommittee, and before hearings at the Internal Revenue Service on many of the issues that are associated with this bill today.

Farm Bureau policy calls for the outright repeal of the estate tax, but barring that event we do support provisions contained in legislation such as S. 2967.

In particular I would like to summarize the comments, and ask that the full statement be included in the hearing record.

Our comments are directed to four provisions of S. 2967. They are: The unified credit; the unlimited marital deduction; the increase in the annual gift tax exclusion; and the special use valuation rules.

The subcommittee has received ample testimony both today and in previous hearings on the effect of inflation on the value of farm estates, and the resulting need to offset the Federal estate tax.

To adjust the unified credit against estate and gift taxes is a matter of equity to farm families faced with rising production costs, depressed commodity prices, and increased land values resulting from inflation. So, specifically, we support the increase in the unified credit that would provide for an equivalent exemption of $500,000.

The same line of thinking follows with the unlimited marital deduction. We believe that it is only fair for a farm husband and a farm wife to be able to take advantage, if they choose, of an unlimited marital deduction because in many ways it does promote the continuation of family businesses, particularly since many of them have been sold in the past to pay the estate tax.

We also support the increase in the annual gift tax exclusion, concurring with previous witnesses that this type of increase is long overdue.

Finally, I would like to comment on the special use valuation provisions of the bill today. Not a week goes by that we don't have some correspondence or telephone calls from State farm bureaus, or individual farm bureau members about the burdens of the special use valuation.

It was originally designed to be a very helpful part of the estate tax law, but due to proposed regulations and more recently the final regulations, I think that several aspects of the regulations have made use of the 2032A very onerous.

In April of 1979, our North Carolina Farm Bureau president, John Sledge, commented to the Internal Revenue Service on both the restrictive aspects of material participation, and upon the difficulties that arise with regard to social security benefits.

In January of this year, vice president Doyle Rahjes of the Kansas Farm Bureau presented testimony to the Internal Revenue Service outlining our concern about the denial of the use of crop shares in the valuation formula under 2032A(e)(7). Our farm bureau policy supports the use of crop shares.

These are basically the points that I wanted to summarize today. We believe that S. 2967 takes care of many of the problems that have been the concern of farm families in the past, and we would be happy to work with the committee in the future with any assistance that we can provide.

Thank you.

Senator BYRD. Thank you, Ms. Rice.

[The prepared statement of Ms. Rice follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
REGARDING ESTATE AND GIFT TAX REFORM

Presented by
Grace Ellen Rice, Assistant Director, National Affairs Division

August 4, 1980

The American Farm Bureau Federation appreciates the opportunity to comment today on S. 2967. Earlier this year, Farm Bureau filed a statement with the Subcommittee on Taxation and Debt Management during its hearing on the effect of the federal estate tax on family farms and small businesses. We are pleased that S. 2967 is the result of that hearing.

Farm Bureau has a long involvement in the federal estate and gift tax area because of the effect that these taxes have upon the well being of the nation's farm and ranch families. Farm Bureau was active in its support for estate tax relief in the Tax Reform Act of 1976 and the Revenue Act of 1978. The continuing interest of our more than three million family membership is reflected in the following policy which was adopted by the voting delegates of the member State Farm Bureaus at the American Farm Bureau Federation's annual meeting in January, 1980.

Federal Estate and Gift Taxes

"We favor a phase-out of the federal estate tax. Until this phase-out is accomplished, we will continue to support legislation to reduce the impact of the federal estate tax on the orderly transfer of property and an exemption for property on which an estate tax has been paid within 15 years prior to the death of the second decedent.

* * * * *

"We favor recognition of the equal contribution of the spouse to a farming enterprise in estate settlements.

"We favor indexing the federal estate tax to compensate for inflation.

"We believe both crop share and cash rentals should qualify in determining the special use valuation of farmland under Section 2032A of the Internal Revenue Code.

"We favor special use valuation of agricultural land for gift tax purposes similar to the special use valuation of such property for estate tax purposes under Section 2032A of the Internal Revenue Code.

"We encourage a reasonable and flexible interpretation by the Internal Revenue Service of the "material participation requirements" for the special use valuation of farmland under Section 2032A of the Internal Revenue Code."

S. 2967 embodies many concepts and provisions of other Farm Bureau-supported legislation pending before the Subcommittee. S. 1825 (unified credit against estate and gift taxes), S. 1859 and S. 2201 (special use valuation), as well as S. 1984 (general estate tax reform), are all within the bounds of Farm Bureau policy. While none of these bills provides for the complete elimination of the federal estate tax, they do allow a greater measure of estate tax relief for farm families.

Farm Bureau's comments are directed to four provisions of S.2967: the unified credit, the unlimited marital deduction, the increase in the annual gift tax exclusion, and the special use valuation rules.

Unified Credit

The Subcommittee has received ample testimony on the effects of inflation on the value of farm estates, and the resulting need to index the federal estate tax to offset it. To adjust the unified credit against estate and gift taxes is a matter of equity to farm families faced with rising production costs, depressed commodity prices, and increased land values resulting from inflation. Specifically, Farm Bureau supports modification of the unified credit to increase the equivalent estate tax exemption to $500,000.

Unlimited Marital Deduction

The use of an unlimited marital deduction would allow the transfer of farm property from one spouse to the other without estate or gift tax liability. Although careful estate planning must be used to achieve maximum benefit for the estates of both spouses, an unlimited marital deduction could reduce significantly the amount of taxes due on the estate of the first decedent. This reduction in estate taxes promotes the continuation of family businesses, particularly since many of them have been sold to pay the estate taxes in the past.

Annual Gift Tax Exclusion

The transfer of farm property by gift is common among farm families. The making of gifts transfers assets from the parent generation of farmers to the children. This not only reduces the size of the parents' estate, but promotes continuation of the family farm. Just as inflation has necessitated an increase in the unified estate and gift tax credit, it has caused the present exemption of $3,000 per year/per donee to become obsolete. Farm Bureau supports an annual gift tax exclusion of $6,000 per year/per donee.

Special Use Valuation

When the special use valuation of agricultural land for estate tax purposes was included in the Tax Reform Act of 1976, it promised to be quite helpful to farm and ranch families, particularly in areas of urban and suburban development. However, during the two year period since the publication of the proposed regulations to implement Section 2032A of the Internal Revenue Code, the provision has been much less of a benefit than originally envisioned. The proposed regulations published in July, 1978, have construed Section 2032A so narrowly that some estates have foregone its use entirely. Two areas in particular have caused major concern to farmers. They are the material participation requirements proposed July 19, 1978, and the definition of gross cash rentals for the special use valuation of farm real estate proposed September 10, 1979.

In testimony to the Internal Revenue Service on April 3, 1979, North Carolina Farm Bureau President John Sledge voiced the concerns of the American Farm Bureau Federation:

> "Farm Bureau supports the Internal Revenue Service in its attempts to prevent abuses in the special use valuation of farm real estate. We are concerned, however, that the proposed regulations may work to the detriment of many farmers, ranchers, and their heirs because of the restrictive aspects of the proposed definition of material participation. The regulations should maintain the flexibility necessary to reflect the intent of Congress to encourage the preservation of family farms.

* * * * *

"The proposed regulations present a double bind to to farmers and their families. First, the restrictive definition of 'material participation' can discourage a decedent-to-be and his or her heir from engaging a nonfamily farm management specialist or firm to operate the farm, although business or family considerations might dictate such services. To employ a non-family member could mean the loss of the special use valuation for the farm. Second, when an owner does participate in the operation of a farm, within the meaning of the proposed rules, the related income becomes earned income under Social Security. Thus, material participation requirements can force a farmer to make a choice between eligibility for social security benefits or eligibility for the special use valuation."

In January, 1980, Doyle Rahjes, Vice President of the Kansas Farm Bureau, presented Farm Bureau's position at the Internal Revenue Service hearing on the definition of gross cash rentals for purposes of the special use valuation of farmland. The definition of gross cash rentals included in the proposed regulations published on July 19, 1978, permitted crop share rentals if no actual cash rentals of comparable real property were available in the locality. The option to substitute crop share figures for cash rent figures is essential in areas of the country where rental operations are conducted primarily under crop share arrangements, a traditionally recognized way of conducting business. Unfortunately, proposed regulations published in September 10, 1979, withdrew this option to farmers and ranchers. In areas of the country where crop share arrangements predominate, such as Kansas and Illinois, it has become impossible to take advantage of the special use valuation under 2032A (e)(7). This leaves the alternative of a more cumbersome valuation procedure under 2032A (e)(8). Mr. Rahjes emphasized the importance of crop shares to farmers and urged the Internal Revenue Service to re-examine its decision to eliminate the use of crop share rentals. In a hearing on March 4, 1980, before the Senate Finance Subcommittee on Taxation and Debt Management, Farm Bureau's position was offered again in support of legislation allowing the use of crop shares as well as cash rentals.

The benefits of special use valuation can be realized by farm families only if reasonable guidelines for methods of valuation and requirements for material participation are presented. To date, the Internal Revenue Service has not offered workable guidelines. Therefore, Farm Bureau supports amendments to the Internal Revenue Code that will provide realistic requirements to qualify for special use valuation. In particular, S. 2967 includes provisions that address the interaction of Social Security benefits and special use valuation, as well as accommodate questions of material participation or active management of surviving spouses, minor children, and other similarly situated individuals who inherit property from a decedent who qualified for special use valuation.

Our testimony today highlights provisions of S. 2967 that are of greatest concern to our membership. Two major considerations are: (1) the need to increase the estate and gift tax credit to compensate for the inflated values of farm estates, and (2) the need to modify the special use valuation rules of Section 2032A. S. 2967 has the potential to ease estate tax liquidity problems, encourage family farming, and simplify estate planning. We appreciate the efforts of Senator Nelson, Senator Byrd, Senator Wallop, and Senator Eagleton to address the problems of farm families as they relate to estate and gift tax law.

The Subcommittee on Taxation and Debt Management is aware of the many problems and needs of farmers and small business owners relating to taxes. Just as S. 2967 makes important changes in estate tax law, S. 2916, a bill introduced by Senator Dole and Senator Talmadge to allow the use of the investment tax credit against the alternative minimum tax, makes an important change in income tax law. Although the bill is not being considered formally by the Subcommittee today, support is offered today by the American Farm Bureau Federation. In the absence of complete repeal of the alternative minimum tax provisions, we support legislation such as S. 2916 that would lessen the effect of the tax by allowing the use of the investment tax credit--a provision that is used widely in the agricultural community. Present law does not permit the al-ternative minimum tax to be reduced currently by the investment credit.

Again, we thank the Subcommittee for its consideration of all tax legislation that is beneficial to the nation's farmers.

Senator BYRD. Mr. Wolf, you may proceed.

STATEMENT OF STEVAN A. WOLF, NATIONAL FAMILY BUSINESS COUNCIL

Mr. WOLF. Thank you, Mr. Chairman. My name is Stevan Wolf, and I am the general manager of a family business, the Letty Lane Co., of Westville, N.J. I am here today on behalf of the National Family Business Council.

It is a privilege again to be part of the committee's vigorous effort to revise and reform our Federal estate tax laws. The National Family Business Council recognizes the significant value of this proposed legislation along with the contributions of Senator Nelson, Senator Byrd, and Senator Wallop. On behalf of family business owners everywhere, we thank you.

On March 24 we appeared here and presented testimony on S. 2220, and made a technical statement to the committee at that time. Those comments basically apply today.

Upon reviewing S. 2967, and the Congressional Record of July 24, 1980, it is quite clear that the sponsoring Senators understand the significance of our Nation's family businesses. S. 2967 is an important first step in helping this segment of our economy grow. Even with all the other measures that will aid our small family businesses, without help from the estate tax burden, many family businesses will die after the first generation.

S. 2967 will assist family businesses in the following way:

Section II will allow for the impact of inflation and keep the very small family business from facing this unknown danger;

Section III will keep the family business from being caught in double jeopardy, tax on both the father and mother's death;

Section IV will allow the passage of most of one's estate during lifetime, providing time and circumstances permit;

Section V will greatly aid our Nation's farmers, and since the overwhelming majority are family businesses, it is an important provision;

Section VII will allow for the payment of gift tax during the lifetime of the donor, thus making the transition of ownership smoother; and

Section VIII will give those family businesses who can finance the tax burden a simpler and more reasonable method to do so.

The National Family Business Council represents over 10 million family businesses, and well over 10 million American families. Not only are we the backbone of our American economy, but we also represent a vital component of the family structure in America. We are not a trade association or a special interest group, nor are we professional lobbyists.

The National Family Business Council seeks, attracts, and is membered by people in a large variety of businesses. Our goal is the survival of family business enterprise in our American economy and society.

The White House Conference on Small Business Report to the President says: "There is a tide in the spirit of individual enterprise in America, and it is rising." The report speaks of "the coming entrepreneurial decade" and supports its statement by the fact that the estate tax recommendations placed fourth among its most important issues.

As stated by the delegates, there must be a revision of the estate tax laws to ease the tax burden on family-owned businesses and encourage the continuity of family ownership.

Many small business owners work hard to build their businesses for their children, and the delegates were concerned that their heirs will have to sell the business to pay the estate tax. This bill, S. 2967, could be the most significant legislation for the future of our free enterprise system, but it does not go far enough.

While the National Family Business Council fully supports this important initiative as a necessary first step, we would like to take this opportunity to offer some suggestions to improve the effectiveness of this bill.

First, there must be more explicit incentives to pass on the family business to its heirs. S. 2967 recognizes the need for such a plan, and does indeed give some relief, yet given the eroding effects of inflation, this proposal falls more in the realm of a catchup program, rather than a positive method to stabilize this sizable section of our economy.

Senator NELSON. Mr. Chairman, may I ask a question?

Senator BYRD. Certainly.

Senator NELSON. The exemption was $60,000 in 1942. Then we increased it to $175,000 for an heir. Have you done any computation so that you could tell us what dollar value exemption today would be equivalent to the $60,000 exemption in 1942?

Mr. WOLF. I cannot say, personally, that I have done anything to compute the rate of inflation, but I am sure that it would not be hard to figure out if I were to go back into our family records. I will do so for you.

Senator NELSON. All I meant was, what is the equivalent dollar value today of the $60,000 exemption that was in the law in 1942. We can compute that, and there is no problem.

Mr. WOLF. Certainly, we are interested in the survival of our family firms, but we are also mindful of the need to preserve the incentive to compete, grow, produce, innovate, and add jobs.

Therefore, we are of the opinion that sections IV, V, VI, VII, and VIII should apply after December 31, 1980, rather than waiting until later on. Only section II has a feasible motive for reaching its limit by 1985. But, a built-in review must be made prior to 1985 in order to update the law taking into consideration the state of the economy at that time.

In addition, serious consideration must be given to the separation of one's business and personal property to allow for better continuity of ownership within one's family. We feel that once this separation is made, the surviving heir working in his family business should receive his business tax free. What better incentive do you need to perpetuate our free enterprise system?

Much more can be done, and much more must be done. The National Family Business Council is continuing to work toward that goal, to seek information that is needed by this committee to help it make its decision.

In response to Treasury looking for more information on this subject, I suggest that they talk to some of the family businesses around this country, and they may get a real good idea of what it takes on the firing line to maintain the family business. We probably can give them all the information they need to make their decisions.

This is a giant first step in eliminating an outdated and burdensome law that has outlived its usefulness. As its name indicates, the family enterprise includes the family and its enterprise in order to maintain our free enterprise system created by our Nation's family business.

Thank you for this opportunity to appear before you on this important matter to the small family business community.

Senator BYRD. Thank you, Mr. Wolf.

[The prepared statement of Mr. Wolf follows:]

STATEMENT OF

STEVAN A. WOLF

ON BEHALF OF

NATIONAL FAMILY BUSINESS COUNCIL

Good morning. My name is Stevan Wolf. I am the General Manager of our Family Business, the Letty Lane Company, Inc., of Westville, New Jersey. I am here today on behalf of the National Family Business Council (N.F.B.C.). As the Government Affairs Chairman of the N.F.B.C., a Trustee of the National Small Business Association, and the N.F.B.C. representative on the Small Business Legislative Council, I would like to comment on Senate Bill S-2967, the "Family Enterprise Estate and Gift Tax Equity Act."

It is a privilege to again be a part of the Senate Subcommittee on Taxation and Debt Management's vigorous effort to revise and reform our Federal Estate Tax laws. The N.F.B.C. recognizes the significant value of this proposed legislation along with Senator Gaylord Nelson, Senator Harry F. Byrd, Jr., and Senator Malcolm Wallop's vital contributions. On behalf of Family Business Owners everywhere, we thank you.

Upon reviewing S-2967, and the Congressional Record of July 24, 1980, it is quite clear that the sponsoring Senators understand the significance of our nation's Family Businesses. S-2967 is an important first step in helping this segment of our economy grow. Even with all the other measures that will aid our small, Family businesses, without help from the estate tax burden, many Family Businesses will die after the first generation.

S-2967 will assist Family Businesses in the following ways:

- Section II will allow for the impact of inflation and keep the very small Family Business from facing this unknown danger.
- Section III will keep the Family Business from being caught in double jeopardy, tax on both the father and mother's death.
- Section IV will allow the passage of most of one's estate during lifetime, providing the time and circumstances permit.
- Section V will greatly aid our nation's farmers, and since the overwhelming majority are Family Businesses, it is an important provision.
- Section VII will allow for the payment of gift tax during the lifetime of the donor, thus making the transition of ownership smoother.
- Section VIII will give those Family Businesses who can finance the tax burden a simpler and more reasonable method to do so.

The N.F.B.C. represents over ten million Family Businesses and well over ten million American Families. Not only are we the backbone of our American economy, but we also represent a vital component of the Family structure in America. We are not a trade association or a special interest group; nor are we professional lobbyists. The N.F.B.C. seeks, attracts, and is membered by people in a large variety of businesses. Our goal is survival of

the Family Business Enterprise in our American economy and society.

The White House Conference on Small Business Report to the President says, "There is a tide in the spirit of individual enterprise in America, and it is rising." The report speaks of "the coming entrepreneurial decade" and supports its statement by the fact that the estate tax recommendation placed fourth among its most important issues. As stated by the delegates, there must be a revision of the estate tax laws to ease the tax burden on family-owned businesses and encourage the continuity of family ownership.

Many small business owners work hard to build their businesses for their children, and the delegates were concerned that their heirs will have to sell the business to pay the estate tax. This bill, S-2967, could be the most significant legislation for the future of our free enterprise system, but it does not go far enough!

While the N.F.B.C. fully supports this important initiative as a necessary first step, we would like to take this opportunity to offer some suggestions to improve the effectiveness of this bill. First, there must be more explicit incentives to pass on the Family Business to its heirs. S-2967 recognizes the need for such a plan, and does indeed give some relief, yet given the eroding effects of inflation, this proposal falls more in the realm of a catch-up program, rather than a positive method to stabilize this sizeable section of our economy. Certainly we are interested in the survival of our

firms, but we are also mindful of the need to preserve the incentive to compete, grow, produce, innovate and add jobs.

Therefore, we are of the opinion that sections IV, V, VI, VII and VIII should apply after December 31, 1980. Only section II has a feasible motive for reaching its limit by 1985. But, a built in review must be made prior to 1985, in order to update the law taking into consideration the state of the economy at that time.

In addition, serious consideration must be given to the separation of one's business and personal property to allow for better continuity of ownership within one's Family. We feel that once this separation is made, the surviving heir WORKING in his Family Business should receive HIS business tax free. What better incentive do you need to perpetuate our free enterprise system?

This is a giant first step in eliminating an outdated and burdensome law that has outlived its usefulness. As its name indicates, the Family Enterprise includes the Family and its enterprise in order to maintain our free enterprise system created by our nation's Family Businesses.

Thank you again for this opportunity to appear before you on this important matter to the Family Business Community.

Senator BYRD. Mr. Lavine from Chippewa Falls, Wis., which State is so ably represented by the chief sponsor of this legislation, Senator Gaylord Nelson.

Senator NELSON. Thank you, Mr. Chairman.

May I say I have known John Lavine for many, many years. He is a highly respected publisher of a chain of family-owned newspapers in the State of Wisconsin. He was a distinguished member of the University of Wisconsin Board of Regents. In particular, he has had a longstanding interest in entrepreneurship and the preservation of family-owned enterprises.

I am delighted, on behalf of the committee, to welcome you here today.

I apologize to the rest of you for getting here late. My plane was 5 minutes late.

Senator BYRD. Mr. Lavine, if you will proceed.

STATEMENT OF JOHN M. LAVINE, PUBLISHER-EDITOR, CHIPPEWA FALLS HERALD-TELEGRAM

Mr. LAVINE. Mr. Chairman, Senator Nelson, members of the committee, my name is John Lavine, and I am the publisher and editor of small daily newspapers in Chippewa Falls, Shawano, Portage, and Baraboo, Wis.

The cities in which our newspapers are located have populations of approximately 6,500 to 12,500. If you could travel through them, you would see towns and surrounding rural areas with about equal mixtures of small businesses, industries, and family-owned farms.

With this as my environment, let me say that I was most pleased to see bill S. 2967. It, along with the suggestions of this year's White House Conference on Small Business are much needed first step toward revitalizing the small, family-owned sector of our economy.

Like you I have read the rather astounding—to me heart warming—figures about what small industries, businesses, and farms mean to the American economic strength. Though we are not listed in the Fortune 500, we produce more jobs, invest more in research and development, and bring into the marketplace more innovations than our giant corporate counterparts.

Since we have accomplished most of this on our own, frankly I wish that it were possible to preserve—let alone enhance—our status in the economy without coming to you, and without legislative help. Yet, after nearly 20 years of reporting on and studying the problems of small businesses, industries, and farms, I am convinced that if our sector of the economy is to be preserved, let alone enhanced, legislation is absolutely vital to accomplish this goal.

In my judgment, S. 2967 begins to redress the problems shared by all of us. Before I briefly make some specific comments on it, let me outline three standards which underlie what I am going to say.

First, I believe that preserving individual and family ownership of businesses will help increase the productivity, competition, and diversity of the Nation's economy.

Yet, you should know that if you had been a reporter in Wisconsin where I live during the 1960's and 1970's, you would have seen firsthand Federal tax laws creating formidable barriers to the continuation of independent ownership of independent businesses, industries, and farms.

Second, neither I nor any of the family-business owners I know believe that we should not pay our fair share of taxes. Indeed, the record will show that we have always paid a higher percentage of our profits in tax than have the giant corporations and conglomerates.

Thus, we are not asking for favors. Rather, we are suggesting that it is a sound investment for the United States to treat our farms, businesses, and industries in a manner which helps us continue to exist and to add, as we do, to the American economy.

Third, many of you know that in the House and Senate, bills have been introduced to protect one group of small businesses—a

group with which I am particularly familiar. That is, independent, often family-owned newspapers.

It will come as no surprise to you that representatives from all of the major daily and weekly newspaper associations formed a task force—on which I serve—to look at this legislation.

Further, I hope that you share with the men and women on that task force a commitment to the fact that the wisest public policy for the continued strength of this country is for there to be the greatest possible diversity of ownership—and as a result diversity of voices—in U.S. media.

What may surprise you, though it only pleased me, is that my colleagues on the task force also are resolutely committed to the fact that it is very unwise public policy for there to be legislation directed only toward preservation or enhancement of independent, locally owned newspapers.

Those of us who own and work for these newspapers feel that it is important that all family business, small businesses, be preserved because only together are we a link in a small economic chain.

With this as a backdrop, let me summarize my comments on the specific parts of the bill.

One. The $500,000 exemption in the bill I think is inadequate, though going a first step. A tornado which swept through our area recently hit many farms and industries, small family-owned, which were worth much more than that. It simply does not keep up with inflation, Senator Nelson.

Two. I think the unlimited marital deduction should be expanded to include other members of the family, else how can you bring in children, cousins, to keep the enterprise family owned.

Three. The $3,000 to $6,000 exemption is adequate for gift tax, but I don't think it is adequate if you look about passing on the business. It seems to me that a special category for passing on a business, similar to passing on a farm, should be considered.

Finally, I think that you ought to look at the valuation that the IRS uses for valuing businesses. Their valuation base, for those of us in the businesses that are affected by multiples and large conglomerates, is far more than we can borrow to pay the tax, and limits our ability as a result to survive.

I have summarized some other comments about specific sections of the bill in my statement, and I will submit those for the committee's consideration.

Senator BYRD. Thank you, Mr. Lavine.

From time to time, I subscribe to newspapers, small papers in various parts of the country, and at one time I subscribed to the Chippewa Falls paper. I was impressed with it. It is a good newspaper.

Mr. LAVINE. Senator, you have made my day coming to Washington. I am basically a carrier boy at heart, and I am happy to know that, especially with your background in newspapers. [Laughter.]

Senator NELSON. Let me say that his papers are lively newspapers of strongly expressed opinions. He utilizes frequently a device from the old history of putting the editorials on the front page. I kind of like it because he is with me 99 percent of the time, and

the other 1 percent he is wrong, but that is a whale of an average. [Laughter.]

Senator BYRD. Speaking of front page editorials, some years ago Arthur Crock, whom all of you know as the longtime chief of bureau of the New York Times, urged me to abolish the editorial page in the paper with which I was associated, and he said: "You ought not to have an editorial page. You ought to write one editorial a day, and put it on page 1." I did not follow his advice, but it is not a bad idea.

Senator Packwood.

Senator PACKWOOD. Let me address this question to the representatives of the farm organizations, unless the other two of you know. On pages 31 and 32 of the Treasury statement, they make reference to a study by Prof. Neil Harl, a professor of economics at Iowa State University. The study is very recent. It was called "Experiences and Problems With 'Use' Valuation of Land," and was presented at a meeting of the Commissioner's Advisory Group, IRS, Washington, D.C., June 9 and 10, 1980.

One of the things that the study concludes—I am quoting from the testimony—

> Professor Harl also questions the premise of Section 2032A, namely, the preservation of the family farm. He indicated that, traditionally most farm and ranch businesses have begun and ended within one generation. Very few farm and businesses have continued as a going economic entity into the next generation.

I have no statistics to refute that. I assume that his study was done on a statistical basis. I am just curious if you have any statistics or feeling about that statement.

Mr. JONES. Senator Packwood, I am B. H. Jones of the National Cattlemen's Association. I have read parts of Dr. Harl's study, but I have not studied it in detail. I am not sure whether his study includes more than the State of Iowa or not.

I think, however, that the utilization of section 2032A since its passage would verify very definitely the popularity of that particular section. If it were not for all the roadblocks that we are running into with IRS, unfortunately, it would be very widely used.

I think that in our segment of the business, the cattle business, I would doubt very much that his statement that most farms last one generation would be true. Based on our membership, this definitely would not be true. It is passed on from one generation to the next.

Senator NELSON. Let me comment on that. I think the statistics, whatever they would be, would underestimate the desire of the young farmer to get on the farm. The Future Farmers of America have a program where they come to Washington, and always come to see their representatives, and last week two young men from my part of the country were in, both of them wanted to be farmers. Both of them were going into agriculture, and neither one of them was going to take over the farm because they cannot get the capital to buy the farm.

So we have another situation going here where there are young farmers who want to take over the parents' farm, but the 20- or 22-year-old does not have the money to buy the farm, and the parents cannot retire on nothing. So they sell it to somebody else to get

their money. So there is another side to the problem here, and it is making money available for a young farmer to take over.

The Minnesota plan, which has been in place for some time, I think we had some hearings on that a year or so ago, is certainly a step in the right direction.

Never does a group come to my office, but there are young men and women who are saying that they would like to farm, but they can't get the money, so they are going into some other aspect of agriculture.

Senator PACKWOOD. What I was curious about is my experience in Oregon. This is just intuitive, but I know many first-, second-, third-, fourth-generation farms. I don't have the statistics, but I know the families are there, and they settled in 1870 or 1880, and many of the farms are still in family hands. Yet, this statement would indicate that maybe that intuitive feeling is just that, and that factually farms are not passed on.

A bright genius starts one at 22 or 23, and lives until he is 70 or 75, and sells out. It is never passed on from family to family. I wonder if the two ladies could comment on that.

Ms. KOBELL. I suppose, and I am certainly far from being a statistician, we have to recognize that within the lifetime of now retiring farmers, or farmers now maybe in their seventies, we have had a dramatic decrease in the number of farms in the United States. At the turn of century we had something like 90 percent of our population living on farms, and now we have about 4 percent, or 3 percent. So, in part, I suppose that would reflect many millions of farms that did not pass on to the next generation.

Like you, my reaction—working with members of the National Farmers Union, knowing and visiting with people—is that there is a strong pattern of handing the farm down where possible. Although quite often—I was thinking of a farm in my own family—the family farm, which is now a viable and operating unit, contains farms that were originally homesteaded by five or six families, but because of the mechanization, because of a lot of the other things, those have been absorbed into one economically viable unit.

I would be interested in a much broader study of the problem. We certainly would join the comments of Senator Nelson that if we are interested, and we believe that it is an important national policy in terms of providing food and fiber for this Nation, to continue a pattern of the family farm agriculture. We must develop programs that make it possible for young men and women to buy farms and operate them.

If that is a national policy, then certainly we need to do much more, beyond the estate tax approach to make it possible for people to get into and—of course to have high enough farm prices among other things—to stay in farming and ranching.

Although we have, as it was pointed out here, farm operations that may be worth one-quarter or one-half of a million dollars—a friend of mine from Minnesota, from a working dairy farm, said: "On paper our operation is valued at one-quarter of a million dollars but my kids qualify for reduced-price lunches because our net income is so low. When you have a 60- to 65-percent parity level, this is what happens in terms of net earnings.

We certainly would be interested in a much broader look, perhaps finding out if this does reach beyond Iowa, and whether it does relate to the change in agriculture.

Mr. JONES. Senator Packwood, might I just add one comment. The liquidity problem, even more than the lack of capital, is one of the big things, and this is where this bill would help immeasurably as far as that particular problem is concerned.

Ms. RICE. As far as the Harl study, I am not familiar with it. I have not read it. Like the other two witnesses here today, I frankly would assume that young men and women who grow up on the farm, and have indicated an interest to maintain it, would not be interested in just continuing it for one generation.

I don't know the statistics, and frankly I am not sure if that really is the case in Iowa. We have not heard that from any of our membership.

Senator PACKWOOD. Let me ask one other question based on the same study. I have not read it either.

In a recent study, Professor Harl concludes that the estate tax shelter provided by Section 2032A would encourage older farmers toward greater investment in land and less investment in nonland assets, and that they would be able to outbid younger farmers for a particular tract of land. Thus, it is expected that additional capital will flow into farmland, driving up the prices, until investors are once again indifferent between investing in farmland with the benefits of use valuation and investing in other assets at fair market value. Therefore, section 2032A has the effect of raising the price of farmland and thereby creating additional entry barriers for farming to younger individuals.

Would you comment on that?

Mr. JONES. Senator, this, as you have read it, has a presumption in it, and it is an extremely erroneous judgment. I know of none of our people who base their decisions in their lifetime with respect to acquiring assets on whether they are going to use 2032A upon their death. Their plans, generally speaking, do not reach this far.

The motivation for buying one asset or another is dependent upon a factor that overrides the consideration with respect to 2032A. I would just say that it is a vision, or a judgment of an academic person which is not connected very much with the real world.

Senator PACKWOOD. My intuitive feelings come down where yours are. I had just never seen the study, or had never seen the conclusion before. It has just been out within the last 3 weeks.

Mr. JONES. That conclusion of the study I did read, and it is an assessment of judgment which to me is erroneous.

Mr. LAVINE. Senator, if I may go back for a moment. We did a study in Wisconsin which was not directly related to your first question but tracks fairly closely. They say you can confirm anything with statistics.

In looking at a school of veterinary science, and as a result the flow of ownership of farms and their change, I think your earlier comment answers part of that, and that is, of course, the generations may not carry on as farms combined, so statistically you can say that there has not been a flowthrough. The question is, What about those that remain on the small farms?

Senator PACKWOOD. The interesting comment was the one "very few farm and ranch businesses have continued as a going economic

entity into the next generation." He is talking about all of them. I am intrigued by the study.

Mr. LAVINE. I have a feeling that this is a game with statistics that can be rather easily shot apart because we do have the ownership tracks, and you can follow those.

Senator NELSON. It would be rather dramatic in our State where in 1950 there were 132,000 dairy producing farms, and it is under 50,000 now. So, obviously, there are thousands that are not dairying now, and when this goes into the statistics it makes a very distorting picture.

Mr. WOLF. Senator Packwood, I would like to add one other thing to that. We have talked to Dr. Leon Danko who is supposed to be the foremost authority on family-run businesses, and he uses the figure that over 50 percent of all family businesses last only one generation. That might help shed some light on it. He does not categorize it by farm, or whatever, but that is a statement that he has used over and over again.

Senator PACKWOOD. It is like the newspaper publisher who had the headline "Fifty percent of the Members of the Legislature are liars." Upon retraction, he said, "Fifty percent are not liars." [Laughter.]

Senator PACKWOOD. I have no other questions, Mr. Chairman.

Senator BYRD. Senator Nelson.

Senator NELSON. I have no questions. Thank you.

Senator BYRD. Thank you, ladies and gentlemen.

[The prepared statement of Mr. Lavine follows:]

TESTIMONY OF JOHN M. LAVINE, PUBLISHER/EDITOR, CHIPPEWA FALLS HERALD-TELEGRAM; PORTAGE DAILY REGISTER; BARABOO NEWS-REPUBLIC; AND SHAWANO EVENING LEADER

Mr. Chairman, Senator Nelson, Members of the Committee, my name is John Lavine. I am the publisher and editor of four small daily newspapers in Chippewa Falls, Shawano, Portage, and Baraboo, Wisconsin.

The cities in which our newspapers are located have populations of approximately 6,500 to 12,500. If you could travel through them, you would see towns and surrounding rural areas with about equal mixtures of small businesses, industries, and family owned farms.

With this as my environment, let me say that I was most pleased to see Bill S. 2967. It—along with the suggestions of this year's White House Conference on Small Business—is a much needed first step toward revitalizing the small, family-owned sector of our economy.

Like you I have read the rather astounding—and to me heart warming—figures about what small industries, businesses, and farms mean to the American economic strength. Though we are not listed in *Fortune 500,* we produce more jobs, invest more in research and development, and bring into the market place more innovations than our giant corporate counter-parts.

Since we have accomplished most of this on our own, frankly I wish that it were possible to preserve—let alone enhance—our status in the economy without coming to you seeking your legislative help. Yet, after nearly 20 years of reporting on and studying the problems of small businesses, industries and farms, I am convinced that if our sector of the economy is to be preserved, let alone enhanced, legislation is absolutely vital to accomplish this goal.

In my judgment, S. 2967 begins to redress the problems shared by all of us. Before I briefly make some specific comments on it, let me outline three standards which underlie what I am going to say.

First, I believe that preserving individual and family ownership of businesses will help increase the productivity, competition, and diversity of the nation's economy.

Yet, you should know that if you had been a reporter in Wisconsin where I live during the 1960's and 1970's, you would have seen firsthand federal tax laws creating formidable barriers to the continuation of independent ownership of independent businesses, industries, and farms.

Second, neither I nor any of the family business owners I know believe that we should not pay our fair share of taxes. Indeed, the record will show that we have always paid a higher percentage of our profits in tax than have the giant corporations and conglomerates.

Thus, we are not asking for favors. Rather, we are suggesting that it is a sound investment for the United States to treat our farms, businesses, and industries in a manner which helps us to continue to exist and to add as we do to the American economy.

Third, many of you know that in the House and Senate bills have been introduced to protect one group of small businesses—a group with which I am particularly familiar. That is, independent, often family owned newspapers.

It will come as no surprise to you that representatives from all of the major daily and weekly newspaper associations formed a task force—on which I serve—to look at this legislation.

Further, I hope that you share with the men and women on that task force a commitment to the fact that the wisest public policy for the continued strength of this country is for there to be the greatest possible diversity of ownership—and, as a result, diversity of voices—in U.S. media.

What may surprise you—though it only pleased me—is that my colleagues on the task force also are resolutely committed to the fact that it is very unwise public policy for there to be legislation directed only towards preservation or enhancement of independent, locally owned newspapers.

Those of us who own and work for these newspapers are proud of what we have accomplished. The problems we have, however, are the same problems of all small business and industry owners.

Not only that, but since we are most often located in regions where our newspapers are but a single link of a regional economic chain that is comprised of family owned farms and many other small industries and businesses—we are fully cognizant that the goal of our continued diversity and strength can only be realized if the common problems which face all small industries, businesses, and farms are solved.

Thus, I oppose special interest legislation for newpapers, and I support general purpose legislation like S. 2967 that deals head-on with the problems that face all small businesses.

Now, with those three standards as the backdrop for my thinking, let me make—in non priority order—some specific comments on Senate Bill 2967:

Section II of the Act increases the tax exemption to a level of $500,000 by 1985. This Section would provide some overall relief to an independently owned business, farm, or industry. However, the overall worth of many of the best small enterprises I know in most instances exceeds the amount contained in this provision.

For example, three weeks ago eight tornados roared through the part of Wisconsin where I live. In a matter of minutes they caused more damage than has any natural disaster in the state's history. The toll will run between $150,000,000 and $200,000,000. Your colleague, Senator Nelson, can tell you—since his staff immediately visited the region and helped us be declared a federal disaster region—what it feels like to walk through what was a day before one of the most beautiful parts of the United States and see what now looks like the aftermath of World War III.

The point of my telling you about the disaster is that head of a town mutual insurance company whose offices are across the street from me told me Friday that if any one of more than a dozen and a half family owned farms he insures were hit, up between one and two million dollars hung in the balance for each of these farms.

You would have to up that value by three or four times or more to describe what was at stake when the tornados slammed into any of the small, independent, often family owned businesses and industries in our area.

From this example, I hope you appreciate my concern about your limiting the estate tax exemption to $500,000.

Next, section III of the bill provides for an unlimited marital deduction. As I understand it, this would enable intra-spousal transfer of property without incurring an estate tax on the value of the property transferred. That is a positive proposal.

However, it does not deal with an equally pressing—indeed for some a more pressing—inheritance problem. That is, how to insure the inheritance of a my small newspaper or any independent business, industry or farm, by the children and, often, other relatives of the owner.

I am not certain, but I believe that the Family Farm act of 1976 has a broader definition in this area. In a similar manner I believe that Section III should be expanded to help continuation of ownership by a family. That will insure the diversity of ownership which makes American small businesses so vital.

Section IV of S. 2967 increases the allowable annual gift tax exclusion from $3,000 per year to $6,000 per year. This jump is welcome—and, in light of inflation, long over due. In fact, I believe it should be far higher.

Now, let me suggest a companion to this increase. That is, neither $6,000 nor twice that amount will insure the preservation of an independent, family owned enterprise. What I suggest is that you add to S. 2967 a provision that allows in-toto the passing on of a family owned business to members of the family.

That leads me to a related suggestion concerning the approach used by the Internal Revenue Service in valuing a farm or business in an estate. Presently, the IRS values many farms and newspapers and some space age small industries based on their potential sale or merger value—whether or not a sale or merger takes place. Such valuations often result in estate taxes which are well beyond the estate's liquidity.

Recently, this impacted on a friend of mine who wanted to keep his newspaper locally owned and carried on by his very able children and a cousin. When he died, my friend had passed some of the newspaper on—but not enough. The IRS came in and said that since the newspaper could be sold for three to six times its gross revenue without respect to profit—and that is a realistic figure—that would be the value on which the estate tax would be based.

When the family went to the bank to try and borrow enough to pay the tax, the bank said that they could only loan money based on a multiple of one—not three to six—times the paper's gross revenue. Further, the bank would take a hard look as its just under 10 percent profit.

As a result, only a fraction of what was needed to pay the tax was available to be loaned, and the paper had to be sold.

In the face of this reality, I recommend that tax laws be changed to allow stock of closely held businesses—just as is allowed already for some family owned farms—to be valued for estate tax purposes on the basis of the business' present and historic financial condition, without regard to sale price or merger values of comparable properties.

At the same time, if you accept my proposal, it would be only fair for you to include in S. 2967 a recapture provision added in the event of timely subsequent sale. The recapture provision will insure that if there is a subsequent sale at an inflated price, appropriately high taxes are collected. In the meantime, this important change in the valuation formula will insure that the independent farm or business is preserved.

Next, I would urge you to add to S. 2967 a proviso that would allow the accumulated earnings penalty tax to be amended so that an independent industry, business, or farm can prepare in advance to redeem stock to pay estate taxes upon death of an owner. Sec. 531 of the tax code requires that accumulations in excess of $150,000 be justified as a reasonable business need.

I recommend elimination of the penalty tax on advance accumulations to pay death taxes (Sec. 303 redemptions) by designating such accumulations as "a reasonable need of the business" for Sec. 531 purposes.

Also, I believe that easing the qualifications test for Sec. 303 stock redemptions to pay death taxes would be wise public policy. The section currently allows capital gains treatment of such redemptions instead of treating them as ordinary income. However, this is allowed only if the value of the closely-held stock being redeemed is at least 50 percent of the decedent's adjusted gross estate. If the estate owns stock in two or more corporations, these interests can be combined for purposes of meeting the 50 percent test only if at least 75 percent of the value of the stock of each corporation is owned by the estate.

I would suggest lowering both of these tests—particularly the 75 percent test for estates owning stock in more than one corporation.

I also believe that redemptions allowed in Sec. 302 (disproportionate redemptions) and Sec. 306 (stock recapitalization) could be valuable tools to help closely-held farms, industries, and businesses remain closely-held. Further, I recommend that the two principal requirements for using Sec. 302 be eased. Sec. 306 stock should again be subject to capital gains treatment.

Finally—and of great importance to those of us in small businesses, industries, and farms—I suggest that the qualifications for extended time payments of estate taxes be eased.

Sec. 6166 and related sections allow 10- and 15-year installment payments if stringent qualifications are met concerning the portion of an estate which contains closely-held enterprises' stock. These sections also concern the number of stockholders in an enterprise.

I hope you will give serious consideration to reduction of the percentage of the estate tests; removal of the limits on the number of stockholders; and elimination of voting stock tests as qualifications for the extended payment provisions.

Mr. Chairman, Senator Nelson and members of the committee, thank you very much for allowing me to testify today.

In the interest of being brief, I have proposed only general additions to Senate Bill 2967. If you would like more detail, I would, of course, be happy to prepare it for you.

In the meantime, I believe that the suggestions I have just outlined will make S. 2967 a better law. They are vital amendments if the goal of maintaining and enhancing small, family-owned businesses, industries, and farms is to be achieved.

If you have any questions, I would be happy to try to answer them.

Thank you very much.

Senator BYRD. The next witnesses will be Robert D. Partridge, executive vice president and general manager, National Rural Electric Cooperative Association; Michael Barry, legislative counsel, National Telephone Cooperative Association. They will discuss S. 2818.

I will point out that the Treasury has no objection to this legislation, indeed, it is supporting it. So I don't know how much time you would want to take. The Senate is now voting. You might want to follow Senator Packwood's suggestion that since there is no opposition, you might want to keep your comments to a minimum. It is up to you.

STATEMENT OF ROBERT D. PARTRIDGE, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. PARTRIDGE. Mr. Chairman, and members of the committee, my name is Robert D. Partridge, and I am the executive vice president and general manager of the National Rural Electric Cooperative Association. With me on my right is legislative representative, Carolyn Herr Watts.

I will summarize my statement very briefly. I would request that it appear in the record in its entirety.

Senator BYRD. It will.

Mr. PARTRIDGE. I am here for the purpose of expressing the full support of NRECA and its member systems for S. 2818, particularly that portion of the legislation which would treat pole rental income as related income. There is no issue before this Congress of more immediate concern to the rural electric cooperatives who make up our membership.

At our last annual meeting, we had a resolution on this matter, and shortly thereafter Senators Talmadge and Nelson introduced S. 2818 addressing specifically the pole tax issue. We are most grateful for the introduction of the bill, and for this hearing on it.

We think the legislation should not have been necessary had it not been for the IRS reversing its position of many years standing. However, it appears that without legislation at this point, it would probably be years before the issue would be resolved, and then only after a great deal of unnecessary cost and manpower expense.

The issue first arose in 1977 when IRS agents auditing Consumers Power, Inc., a rural electric cooperative located in Corvallis, Oreg., questioned whether pole rentals were unrelated business income.

Again, the final court resolution of that dispute, which is in the courts, has a uncertain time frame, and undoubtedly it will take a

number of years. In the meantime, auditing activities such as this are occurring around the country.

A favorable decision in the Federal court in Oregon would not be binding, of course, on any of the other Federal court districts. Without legislation such as S. 2818, with its retroactive provision, it is almost impossible to project either the final resolution of the matter, or the magnitude of the wasted time and money.

It seems inconceivable to these systems that an activity carried on since the 1940's and examined by the IRS in numerous instances could suddenly be determined to be unrelated and subject to income tax. It is difficult for them to understand the inflexibility of an interpretation of law which is totally contrary to previous determinations.

We are in considerable disagreement with IRS on its position. Basically, our objections are twofold. We think the Service's position is not in the public interest; and that the Service's position is not defensible from a legal perspective.

It is clear from the legislative history of the Rural Electrification Act from the very beginning that Congress intended, and REA has endeavored through its programs, to bring about the joint-use of poles and other facilities wherever it makes good sense for the public interest.

We think the most important point to be made is that an examination of the legislative history surrounding the unrelated business income tax provisions of the Internal Revenue Code leads one to conclude that the tax was not intended by Congress to apply to revenues such as pole rentals.

The tax was aimed at unfair competition, as the committee is well aware. There is no issue of competition where pole line attachments are involved, and there never really has been.

I would further like to note that Federal, State, and local governments encourage and, in some cases, mandate the joint use of utility poles.

Let me, in conclusion simply reassert NRECA's support for S. 2818. We think that the unrelated income portions of this bill merely clarify the existing law, and in no way change it.

We are again appreciative of appearing before this committee to state our views and positions.

Senator BYRD. Thank you.

[The prepared statement of Mr. Partridge follows:]

STATEMENT OF
ROBERT D. PARTRIDGE
EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Chairman and Members of the Committee: My name is Robert D. Partridge, Executive Vice President and General Manager of the National Rural Electric Cooperative Association (NRECA). I am accompanied here today by NRECA Legislative Representative, Carolyn Herr Watts. NRECA is the member-service organization of the more than 1000 rural electric systems providing central station electricity to more than 25 million consumers in 2600 of the nation's 3100 counties in 46 states.

My testimony today is for the purpose of expressing the full support of NRECA and its member systems for S.2818, particularly that portion of the legislation that would treat pole rental income as related income. It is difficult to envision an issue that has broader application to our members than the one dealt with by this bill. Certainly there is no issue before this Congress of more immediate concern to our membership. This concern was expressed by the following resolution unanimously adopted by some 11,000 delegates to NRECA's 1980 Annual Meeting.

Poleline Attachments/Related Business Income

> To serve the public interest, to promote rural development, to avoid duplication of utility poles, to protect against an unsightly environment, and to bring service to the greatest number of people at the lowest possible cost, the rural electric systems have entered into reciprocal agreements to share the cost of using and maintaining their utility poles. Joint use minimizes costs and encourages the efficient use of rights-of-way. Traditionally the Internal Revenue Service (IRS) has treated revenue resulting from joint use agreements as business-related and thus non-taxable. However, recently, the IRS has shifted this long-standing policy and has begun taxing this income, claiming that the rental bears "no substantial causal relationship" to the rural electric cooperative's exempt purpose. To take issue with the IRS, we believe the purpose of rural electrification is to provide full and adequate service to cooperative members.
>
> We, therefore, support legislation introduced by Congressman Albert Gore, Jr.

> of Tennessee entitled THE RURAL COOPERATIVE BUSINESS INCOME ACT. This bill will treat as related income, revenue received for activities normally provided by an electric utility.

Subsequent to the passage of this resolution, Senators Talmadge, Baucus and Nelson of the Senate Finance Committee introduced S.2818 addressing specifically the pole attachment issue. We wish to express our deep gratitude to the sponsors of this bill and for the opportunity of testifying here today. We believe this legislation should never have been necessary and that our systems' legal challenges of the IRS' that pole rental income is unrelated and, therefore, taxable would ultimatley prevail in the Courts. However, without legislation it would be years before the issue could be resolved and, only then, after a great deal of unnecessary cost and manpower expense.

This matter first arose in the summer of 1977 when IRS agents auditing Consumers Power, Inc., a rural electric cooperative located at Corvallis, Oregon, questioned whether pole rentals were unrelated business income. In order to obtain a determination on this issue, the agent asked for a National Technical Advisory Opinion. The cooperative came to Washington in November, 1977 for a national conference with the Service and filed its brief setting forth its arguments as to why these rentals were not unrelated income.

In March, 1978 the Service determined that income received by the cooperative from the leasing of space on its utility poles is subject to the unrelated business income tax. The system was not billed by the IRS until May, 1979, at which time, it paid under protest and requested a return of the monies paid. The request was in effect denied by the expiration of six months time, as after this lapse such requests are considered automatically rejected. On March 5, 1980 suit was filed in the Federal District Court for the State of Oregon for return of the monies paid under protest. Court prehearing conferences thus far have resulted in a stipulation by the Government to finish its discovery by December 26, 1980 and to expedite the case. A final court resolution time frame is uncertain, but surely it would be years from now.

In the meantime, activities such as this are occurring around the country. A favorable decision in the Federal court in Oregon would not be binding in other Federal court districts. Without legislation such as S.2818 with its retroactive provisions, it is almost impossible to project either a final resolution of this matter or the magnitude of wasted time and money.

Since the IRS ruling in March, 1978, cooperatives around the country have been the targets of audits, requirements to file 990-T's, and assessments. I know of no cooperative that has not taken the position that the IRS is wrong from both a legal and public policy standpoint.

It seems inconceivable to these systems that an activity carried on since the 1940's and examined by the IRS in numerous instances could suddenly be determined to be unrelated and subject to income tax. It is difficult for them to understand the inflexibility of an interpretation of law which is totally contrary to previous determinations.

Our members become even more suspect of the IRS' motives when the cooperatives' expense methodologies are rejected, with the Service allowing deductions of offsetting expenses for only the few inches actually used for the line attachment. We are yet to find an attachment 20 feet off the ground that needs no support from below.

As the Committee is by now aware, we are in substantial disagreement with the IRS over its position. I will from this point forward be more specific. My objections are basically twofold:

1. The Service's position is not in the public interest and;
2. The Service's position is not defensible from a legal perspective.

Let me initially say that it is difficult to accept that any activity carried out by every segment of the utility industry could be unrelated to the purpose for which the utility does business. In this case it is the rental of space on utility poles for attachments of other lines, specifically telephone or cable TV. All segments of the utility industry whether investor-owned, municipally-

owned, or cooperatively-owned rent space on their poles for utility attachments and have done so for years. It is an integral component of providing electrical service.

The legislative history of the Rural Electrification Act of 1936 and the 1949 rural telephone amendments to that Act establish that their purposes are to enhance the public good by providing rural areas with area-wide coverage of central station electricity and telephone service. The Committee reports accompanying the telephone amendments to the Rural Electrification Act of 1949, in fact, specifically noted that telephone service and the joint use of poles would facilitate the implementation of Congress' intentions as expressed in the Act of 1936 and amendments of 1949. Language in Senate Report No. 1071, 81st Congress, 1st Session reads:

> In fact the lack of good rural telephone systems is even working hardships on the extension of electrical service to rural areas because the farmer is unable to notify the local company or cooperative that the electrical service is broken down.

Additionally, it should be noted that Congress' purpose in the granting of tax exemption to the nonprofit telephone and electric utilities was due to the fact that such nonprofit cooperative utility businesses serve the public good. It would appear to follow that activities which contribute importantly to serving the public good, rather than a private profit interest, are substantially related to the exempt purposes and, therefore, do not result in taxable business income. Further credibility is lent to the argument by a decision in the United States Court of Appeals for the Sixth Circuit in <u>United States v. Pickwick Electric Membership</u> Corporation, 158 F.2d 272, 35 AFIR 272 (1946). The Court noted that rural electric cooperatives are exempt not only because of the provisions of 501(c)(12) but are also exempt as organizations "operated exclusively for the promotion of social welfare" as provided in Section 501(c)(4), IRC.

Possibly, the most important point to be made, we believe, is that an examination of the legislative history surrounding the

unrelated business income tax provisions of the Code, leads one to conclude that this tax was not intended by Congress to apply to revenues such as pole rentals. Congressional concerns over the expansion of tax-exempt entities into a wide range of business activities led to the concept of "unrelated business income." This concept resulted in the enactment of the "unrelated business income" tax in 1950 and 1969 (when it was extended to apply to 501(c)(12) organizations). This tax was aimed at unfair competition. That is, if tax-exempt entities were expanding into unrelated areas and, therefore, unfairly competing with taxpaying organizations, such activities should be taxed. Clearly, there is no issue of competition where pole line attachments are involved. The electric utility industry is a rigorously regulated monopoly; each utility serves well-defined geographical territories. We believe the IRS recognizes this Congressional intent through Regulation 1.513-1(b) which states that the primary objective of the unrelated business income tax is "to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."

We would also like to note that Federal, State and local governments encourage in some instances, and mandate in others, the joint use of utility poles. There are numerous examples and references we could use to support such a statement but will note only a few.

REA requirements, as expressed in numerous bulletins, encourage and mandate the joint use of poles for safety, health, economic, environmental, and public interest reasons. REA makes loans available to borrowers for the installation of poles capable of joint use and for other increased plant and equipment costs associated with joint use. Certainly REA lacks the power under the Rural Electrification Act of 1936 to loan money for or require an electric borrower to engage in any business which is not related to "the furnishing of electricity to persons in rural areas who are not receiving central station services."

Other Federal agencies, such as the Interior and Agriculture Departments, mandate joint use in crossing Federal lands. The National Electrical Safety Code requirements mandate joint use as do Federal, State, and local environmental laws.

State regulatory commissions generally require joint use reciprocal agreements of the utilities they regulate. These commissions could hardly be accused of requiring their regulated utilities to engage in activities unrelated to their purpose.

Joint use is safer for operation and maintenance purposes than dual facilities. It is also safer for the general public. Technical problems such as interference with communication equipment can be avoided by this type coordination. Adverse impacts on the environment, land uses, land values and aesthetics are also minimized as is the chance that landowners will be more reluctant or refuse to grant dual rights-of-way. Control points are frequently identical if more than one utility needs to follow a common routing. Finally, without reciprocal contracts, other utilities would refuse to allow cooperatives to attach to their poles.

In the IRS opinion of March, 1978 that pole rental revenues are unrelated income, a great deal of reliance seems to have been placed on the Service's interpretation of the definition of "unrelated trade or business" as defined in section 513 of the Code. Basically, it is defined as "any trade or business the conduct of which is not substantially related ... to the exercise or performance by such organizations" of their exempt function purposes. For numerous reasons already referred to, we believe the leasing of pole space is substantially related to the cooperatives' exercise or performance of the purpose and function constituting the basis for their exemptions under 501(c)(12) of the Code.

Section 1.513-1(b) of the Regulations defines "trade or business" as generally including "any activity carried on for the production of income from the sale of goods or performance of services." Our members have uniformily argued that they are not in a "trade or business" within the meaning of this regulation as the activity is an integral part of providing electric service. Additionally, as pole rental attachment rates are based on a sharing of costs,

the activity is not one carried on for the production of income. Essentially, the money received is a mere portion of the expense and any realistic analysis of the rates charged by the cooperatives will find that in most cases the money received does not fully reimburse the system for the actual costs incurred.

It has also been argued by our members that this income is "passive" income as opposed to "active" and, therefore, is clearly not unrelated business taxable income.

NRECA has also met to discuss our members' problems with government representatives whose concern is tax policy. It was our impression that they were primarily interested in two areas: (1) Is this activity competing unfairly with a taxpaying business? and, (2) In the case of cooperatives, is one group of members subsidizing another? As to the first of these questions, we believe the answer is clearly, no. We have already addressed this issue today. We also believe that there is, or should be, no subsidization issue either; however, we are concerned that this could be a problem if the IRS prevails with its expense methodologies. REA and other regulators have encouraged fair rental rates for pole space to avoid such problems as the subsidization by electric consumers of telephone and cable TV subscribers. The IRS position that attachment expenses and rates only apply to a few inches of pole space would imply that electric subscribers should subsidize companies leasing their poles.

Mr. Chairman, there are many other legal and public interest arguments that could have been presented here today. Our members have been diligent in their communications on this issue with the IRS. The cooperatives have submitted many briefs to the IRS. Should the Committee desire, NRECA will make available any such documents in our possession. Among these submissions to the IRS are: (1) briefs that met with a favorable response from the IRS (that is, pole line attachment income was determined to be related and not taxable), (2) the Consumers Power, Inc. brief (the lead case in this controversy), and (3) other submissions that have not yet received determinations from the IRS.

My testimony today has dealt with that portion of the legislation which would treat pole rental income as related and, therefore, not taxable. We do support the concept embodied in this legislation that this income should not be considered nonmember income in light of the public interest served by the performance of this activity and that pole attachments are frequently mandated by law. It is not, however, of great significance to the vast majority of our members whose nonmember income is generally below 5 percent of their revenues with pole line rental income being a small portion of those revenues.

In concluding, let me once again reassert NRECA's support for S.2818. We believe that the unrelated income portions of this bill merely clarify existing law and in no way change it. As previously stated, NRECA contends that the IRS' position on these revenues is wrong from both a legal and public perspective. The treatment of pole rental income as member income under this bill is not of as great significance to our distribution members as few if any are threatened with a loss of their tax exempt status due to nonmember income. Finally, we believe the retroactive provisions of this legislation are essential to avoid further costly and unnecessary litigation and that the revenue impact on Treasury will be insignificant since we know of only one cooperative, Consumers Power, Inc. that has paid this tax.

We appreciate the opportunity of expressing our views and those of our members.

Senator BYRD. The Treasury has testified that it supports the legislation, so I don't think you will have too much trouble with the committee.

The Senate is now voting. The committee will necessarily stand in recess for 15 minutes so that the members of the committee can vote.

[Recess.]

Senator BYRD. The committee will come to order.

Mr. Barry.

STATEMENT OF MICHAEL BARRY, LEGISLATIVE COUNSEL, NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Mr. BARRY. Mr. Chairman, my name is Michael Barry, and I am legislative counsel of the National Telephone Cooperative Association. Appearing with me is Robert Lee, Director of Legal and Industry Affairs. Our association represents 247 rural telephone cooperatives who serve about 800,000 people.

We support S. 2818. In recent years some IRS agents have challenged the revenues received by the telephone cooperatives in the two areas addressed in the bill: Telephone directory display listings, or Yellow Page ads, and pole-rental income.

The IRS agents have determined that telephone directory display advertising is subject to unrelated business income test. We disagree strongly with that interpretation because we believe these ads provide important information to our subscribers regarding the services rendered, hours of businesses, and acceptable credit cards.

It helps the subscribers use the directory efficiently. We believe there is a substantial causal relationship between the directory display information and our tax exempt function of providing telephone service.

Telephone cooperatives do not print Yellow Page directories. They are printed by national companies who contract with the cooperatives and sell display listings directly to merchants and businesses. Thus, telephone cooperatives are not competing with any other business in publishing Yellow Pages. Yet, due to the IRS ruling regarding the directory display ads, cooperatives must apportion their whole directory between related information and unrelated advertising.

It does not matter whether the advertiser is a local merchant subscriber, or a national advertiser. All display advertising is aggregated in the 15-percent nonmember income test for the 501(c)(12) exemption. We are most concerned that these revenues, which amount to less than $100,000 nationally when combined with revenues from such activities as overnight parking for schoolbuses, interest and pole rentals, will increase the nonmember income above the allowable 15-percent level and destroy the cooperative's tax exempt status.

Our other area of concern regards the IRS treatment of pole rentals as unrelated business income. REA, the major source of loans for rural telephone development, has encouraged telephone and electric cooperatives and cable television companies to make common agreements to share space on utility poles.

This practice encourages the efficient use of rights-of-ways, and eliminates unsightly clutter of poles and wires.

S. 2818 resolves the two taxation problems in different ways. First, it states that the sale of display listings in the telephone directory furnished to the members of the mutual or cooperative telephone company will be treated as member-related income. This clarification prevents the IRS from treating display listing revenues as nonmember income for the purpose of the 85-percent member income test. Thus, the 501(c)(12) status of the telephone cooperative is not endangered while the IRS may continue to collect taxes on the unrelated business income as provided in section 512.

S. 2818 treats the problem of pole-rental income by adding a new subsection to section 513 of the code for unrelated business income, which excludes qualified pole rentals for the transmission of telephone communications.

Mr. Chairman, NTCA supports the approach taken in S. 2818 to resolve these problems. We thank you for the opportunity to testify.

Senator BYRD. Thank you, Mr. Barry.

As best as I can judge, this legislation is not too controversial.

[The prepared statement of Mr. Barry follows:]

STATEMENT OF THE

NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

BEFORE THE SENATE FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

PRESENTED ON AUGUST 4, 1980

Mr. Chairman and members of the Subcommittee, my name is Michael Barry, and I appear before you today in my capacity as Legislative Counsel of the National Telephone Cooperative Association.

The National Telephone Cooperative Association (NTCA), is a nonprofit trade organization representing over 358 small, rural telephone cooperatives and locally owned and operated commercial telephone systems. Our appearance today is on behalf of our 247 telephone cooperatives. NTCA wishes to express its appreciation to the Chairman and Members of the Subcommittee for the opportunity to testify regarding S.2818, A Bill to Amend The Internal Revenue Code of 1954 With Respect to the treatment of Mutual or Cooperative Electric and Telephone Companies.

SUMMARY

NTCA supports S.2818. The bill clarifies the intent of Congress regarding the status of telephone cooperatives' directory display advertising and telephone pole rental agreements. Revenues from telephone display listings cannot be treated as non-member income for purposes of the 85% gross revenues test of Section 501(c)(12); however, the income may be subject to the unrelated business income tax. Revenues from telephone pole rental agreements are related to the cooperatives' exempt function.

Mr. Chairman, I testify in support of S.2818. This bill amends the Tax Code as it relates to telephone directory display advertising and pole rental income of telephone cooperatives. These same issues were raised in H.R. 5643, as sponsored by Mr. Gore (Tenn.) and approximately 120 additional co-sponsors.

Telephone cooperatives are in business solely to provide their subscribers the same quality of telephone service that is available to urban subscribers. However, the areas in which these cooperatives operate are so remote, so difficult to serve that it is most difficult to provide telephone services comparable to those enjoyed in urban communities. Because of this situation, Congress recognized a need to provide income tax relief to foster the establishment and operation of telephone cooperatives and Congress did so under the Tax Code - Section 501(c)(12). This section specifically exempts the income of telephone cooperatives; "but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses" in the provision of telephone services.

Telephone cooperatives began in the early part of the century when hundreds and hundreds of non-Bell companies were formed. Cooperatives were organized in the most rural areas where entrepreneurs found the low density uninviting for investment in the telephone business. Many of these

systems were technologically crude and were not maintained or improved as the plant wore out or became obsolete. The rural depression beginning in the 1920's as well as the electrification of the rural areas in the 1930's contributed to the demise of hundreds of these cooperatives and other small independents. At the end of World War II, less than 40% of rural homes had telephone service.

The 1949 amendments to the Rural Electrification Act for the first time provided a sound source of capital for modernization and construction for small rural systems. Today, there are 247 cooperatives in 30 states with assets of about one billion dollars and annual revenues of 175 million and about 5000 employees.

Telephone cooperatives serve 768,000 subscribers, which constitute less than 1% of the total in the United States. They are, nevertheless, proud of the modern efficient telephone service which they have brought to areas in which service was believed to be economically unfeasible. Cooperatives are an important element in fulfilling the congressional purpose of Rural Electrification Act: "... that adequate telephone service be made generally available in rural areas..." (7 U.S.C. Section 921).

Prior to 1950, all income of a cooperative as a tax exempt organization, regardless of its source, was exempt from Federal income taxation as long as the profits derived were dedicated to the organization's exempt purposes. In

1950, the Treasury Department pursuaded the Congress that certain tax exempt organizations were engaging in unrelated business activity involving unfair competition with tax paying entities. These included:

1) Business activities in direct competition with commercial organizations;
2) Sale and lease back arrangements; and
3) The use of "feeder" corporations engaged in business ventures, e.g., New York University's macaroni business.

The Tax Reform Act of 1950, in Sec. 501(c)(12), exempted telephone cooperatives. They were, however, in the Tax Reform Act of 1969, subjected for the first time to unrelated business income.

In recent years, some I.R.S. agents in various states have challenged two minor sources of telephone cooperatives' income; directory display advertisements and pole rental agreements. Together, these two categories do not represent more than $100,000 worth of telephone cooperative income. The cost of audits and litigating these issues, however, has become a burdensome expense. We consider both activities to be an essential part of telephone service to our cooperative member-subscribers.

The IRS issued a Technical Advice Memorandum in 1977 which determined that telephone directory display advertising is subject to unrelated business income tax. In the classified section of the telephine directory, commercial

subscribers are organized according to their types of business or professions. For an additional charge, they may place an advertisement in the section describing the particular type of merchandise or service offered, providing the contents of the advertisement meet the approval of the cooperative. NTCA believes that this advertising provides information for cooperative member-subscribers and the cooperative.

Information in the display ads describes the products carried, services rendered, acceptable credit cards, hours of business and similar information. Advertisers may be either local merchant/subscribers such as the drug store, chain grocery store or plumbing service, as well as national advertisers such as airline companies, car rental companies and manufacturer's service centers. The I.R.S. has challenged the tax returns of several telephone cooperatives and declared this revenue as non-member income.

Although the IRS agrees that the directory provides useful information and is a convenience to its subscribers, the IRS memorandum concludes that this advertisement does not satisfy the test of a "substantial causal relationship" to the exempt purpose or function of the telephone cooperative.

The IRS has ruled, however, that the printing of the business name in boldface in the regular classified listing is within the Cooperatives' exempt function. The service rationalizes that "no additional information of a commer-

cial nature is contained in the boldface listing as compared to the regular typeface and the overall size of the two types of listings is approximately the same."

We have disputed the reasoning of the technical memorandum regarding telephone display advertising because we believe that a telephone cooperative, like other telephone companies, must provide a telephone directory to their subscribers. It is apparent that telephone systems could not operate efficiently without an alphabetical and classified listing of telephone number.

Telephone cooperatives do not print the "Yellow Pages" directories. They are printed by national companies who sell display listings directly to merchants and businesses. These merchants and businesses buy the display ads to assure that the public knows precisely what products or services they provide. The subscribers depend on this information which actually improves access to telephone numbers and the efficiency of both the telephone system and its directory. For rural consumers, this service is vital due to the limited number of suppliers and the considerable distances between residents and the businesses. Telephone display advertisements in directories are not in direct competition with any commercial organizations. They are a unique service provided by telephone systems which we consider an essential part of our business.

The display listings have been considered by the I.R.S. as regular commercial advertisements if they contain more than the subscriber's name, address, and telephone number.

Any additional information contained in display advertising is considered taxable and the whole directory must then be apportioned on a linage basis between related information and unrelated advertising. It does not matter if the advertiser is a cooperative member-subscriber or not. All of this revenue is considered non-member and is aggregated in the 15% non-member test of gross revenues for the basic 501(c)(12) exempt organization status. Clearly the small amount of taxes collected from this source does not justify the costs involved in making this determination, nor the impact on telephone service which a loss of the exempt organization status would imply.

We strongly believe that directory display advertisement is a business-related activity. We believe that this activity is directly related to offering telephone service and does not fit within the definition of unrelated business income. Section 512 defines it as "the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed."

Section 513(c) provides that the term "trade or business" includes

> "any activity which is carried on for the production of income from the sale of goods or the performance of services. For the purpose of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."

The term "unrelated trade or business" is defined in Section 513 as "any trade or business the conduct of which is substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function consituting the basis for its exemption under section 501..."

As discussed above, we believe strongly that the information and convenience provided by directory display advertising is substantially related to the telephone business. However, we are more concerned with the IRS rulings which include this gross income with other unrelated business income. When revenues from directory display advertisements are added to income the cooperative may derive from other sources, such as rent from overnight parking of school buses, interest, or telephone pole rental income, it may exceed the 15% non-member income test. Thus, the cooperative would lose its exempt status for engaging in activities that are essential and indispensible in fulfilling its rural service obligations.

Our other area of concern involves pole rental income, revenue treated as unrelated business income. Telephone cooperatives, electric cooperatives and some cable television companies make agreements to provide space on their utility poles so that more than one utility service can

use the same pole. For the use of this space, the telephone cooperatives receive compensation that reduces the effective overall cost of installing and maintaining these poles. Joint use of telephone poles encourages efficient use of rights of ways and eliminates the unsightly clutter of poles and wires. The Rural Electrification Administration (REA) the principle lender of funds to telephone cooperatives, encourages this joint use of telephone poles whenever possible and has issued model contracts for that purpose.

Some of our telephone cooperatives have had their books open for several years because I.R.S. agents have challenged the revenues derived from telephone pole rental agreements. Cooperatives have been unable to distribute capital credits to their members.

In a National Technical Advisory issued in February, 1978, the I.R.S. determined that pole rentals received by a distribution electric cooperative through its joint use arrangements with telephone companies, telephone cooperatives, other electric utilities and cable television companies are not substantially related to the primary business purpose and exempt functions of the cooperatives under Section 501(c)(12) and are, therefore, subject to unrelated business income tax.

Our cooperatives have argued that the leasing of space on its poles does not constitute a trade or business because it is not an activity carried on for the production of income from the sale of goods or performance of services.

Rather, the leasing is a mere cooperative and mutual transaction permitting both parties to avoid incurring certain costs associated with alternative means of achieving the same goal.

The I.R.S. has found that these rental agreements are related to the exempt nature of the telephone cooperative. However, the I.R.S. has determined that the degree of the relationship does not pass the "substantial causal relationship" test under Section 513. Currently, there are a number of cases in litigation to determine the "substantial causal relationship" test.

S.2818 resolves the taxation problems of telephone display advertising and pole rental agreements in two separate manners. First, it clarifies the Congressional intent in the 1954 amendment to 501(c)(12) regarding telephone display advertising. It states that "the sale of display listings in a (telephone) directory furnished to the members of the mutual or cooperative telephone company" will be treated as member income. The exemption for telephone cooperatives in 501(c)(12) remains tightly written regarding the requirement that 85% or more of gross income must be collected from "members for the sole purpose of meeting losses and expenses."

In other words, S.2818, declares that all income from display advertising in a local telephone cooperative's yellow pages cannot be treated as non-member income by IRS

for purposes of the 85% gross revenues test. By so designating the display ad revenues, the 501(c)(12) status of the telephone cooperative is not endangered, while the I.R.S. may continue to collect tax on that unrelated business income as provided in Section 512.

Income derived from telephone pole rental agreements is treated in the second part of the bill. The bill adds a new subsection to Section 513 of the Code for unrelated business income.

> "Certain Pole Rentals - In the case of a mutual or cooperative telephone or electric company described in section 501(c) the term "unrelated trade or business 'does not include engaging in qualified pole rentals as defined in Section 501(c)(12)(D)."

The bill states that the pole in question is used for "providing telephone or electric services to its members, -- and in connection with the transmission by wire of electricity or of telephone or other communications."

NTCA believes that the approach taken in S.2818 in resolving these problems is a reasonable one. Since telephone cooperative income from directory display advertising and pole rentals is only about $100,000 nationally, the bill would resolve numerous cases in litigation and free I.R.S. agents to pursue other tax matters.

We believe, Mr. Chairman, that Congress never intended to jeopardize the viability of telephone cooperatives by terminating their tax exempt status because of the income in

dispute in these two categories. Telephone cooperatives are essential to rural Americans who live in areas where commercial telephone interests found it uneconomical to serve. We support S.2818 because it will clarify the intent of Congress regarding the status of telephone display advertising and pole rental revenues. Our cooperatives will be free from the burden of expensive and time-consuming audits and litigation and will be able to devote their energies and resources to providing quality telephone service to the rural subscribers they serve.

We ask the members of the Subcommittee to support this legislation. We thank you for the opportunity to present testimony on this important matter to our telephone cooperatives.

Senator BYRD. The next witness is Malcolm R. Lovell, president, Rubber Manufacturers Association.

I understand that Treasury supports S. 2904 in which you are interested, Mr. Lovell?

Mr. LOVELL. Yes.

STATEMENT OF MALCOLM R. LOVELL, PRESIDENT, RUBBER MANUFACTURERS ASSOCIATION, ACCOMPANIED BY ROBERT SCHARLOTTE, ASSISTANT COMPTROLLER, THE GOODYEAR TIRE & RUBBER CO.

Mr. LOVELL. Thank you, Mr. Chairman.

I have with me Robert Scharlotte, assistant comptroller of the Goodyear Tire & Rubber Co.

Senator BYRD. Glad to have you.

Mr. LOVELL. I will try and be very brief on this because, as you say, this not only has Treasury's support, but in a very real sense the Treasury and we were the originators of this bill. They feel almost as strongly as we do about it.

Mr. Chairman, the subject matter of the bill should be familiar to the committee since prior bills directed to the same problem in the 95th and 94th Congresses were favorably acted upon by the committee, the House, and by the House Ways and Means Committee, and would apparently have been enacted but for having been reported out so close to adjournment.

Although the prior bills were not opposed by the Treasury Department, S. 2904 was prepared as a new approach at the affirmative suggestion of Treasury and has been brought forward with its support.

Given the urgent need for action, we hope that this joining by the industry in the Treasury proposal will now permit the swift adoption by the Congress in this session of the definitive legislative solution embodied in this bill.

Specifically, S. 2904 would simplify the manufacturers excise tax laws on tires by removing Internal Revenue Service regulation from tire warranty adjustment procedures involving manufacturers at both the dealer and consumer levels, by:

One, denying the manufacturers a credit or refund of excise tax, hitherto administratively allowed, where a tire fails to give normal use and a warranty adjustment is made;

Two, providing an equivalent overall adjustment in the excise tax rate, this reduction reflecting the warranty adjustment experience for the tires; and

Three, maintaining for the necessary 2-year transitional period from enactment the tire excise tax warranty adjustment procedures used administratively for almost 50 years, thereby avoiding a requirement for two administratively costly transitions in a brief period.

In conclusion, S. 2904 is a sound solution to currently pressing excise tax administrative problems, would simplify the tax laws on an essentially revenue-neutral basis, and bring about greater uniformity of treatment, is supported by both industry and the Treasury Department, and the Rubber Manufacturers Association, therefore, urges its immediate enactment.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir.

Do you have any comments that you would like to make?

Mr. SCHARLOTTE. I don't think that I have to add anything except, amen.

Senator BYRD. I might say that Goodyear has a very fine plant at Danville, Va. I know many of the executives and many of the employees. I have been through the plant. I know the name of most of the working people in the plant.

Mr. SCHARLOTTE. They build truck tires there, some of the very best facilities in the country.

Senator BYRD. How many employees do you have there now?

Mr. SCHARLOTTE. There are about 1,800 or 2,000 employees at Danville, I believe.

Senator BYRD. They are fine people in that area, and I am glad that they have Goodyear there.

Mr. SCHARLOTTE. Thank you, sir.

Senator BYRD. Thank you, gentlemen.

[The prepared statement of Mr. Lovell follows:]

SUMMARY OF PRINCIPAL POINTS

Statement by
Malcolm R. Lovell, Jr., President
Rubber Manufacturers Association
August 4, 1980

A. Present law imposes a manufacturers excise tax on tire manufacturers at the time of sale by them of tires, tubes and tread rubber. When a tire fails to give normal use and a warranty adjustment is made on behalf of a customer, such adjustment includes the appropriate portion of the excise tax. Under existing administrative procedures, the manufacturer is entitled to a credit or refund for amounts representing the excise tax portion of such warranty adjustments.

B. Present procedures for tire warranty adjustments are administratively costly and unnecessarily burdensome.

1. Of roughly $20,000,000 in excise tax warranty adjustments made annually in the United States, individual excise tax credits or refunds are typically small, often between $1.00 and $2.00.

2. Extensive documentation through the consumer/distributor/manufacturer levels of the Internal Revenue Service is nonetheless required in support of each credit or refund allowed.

3. Changes proposed by Rev. Rul. 76-423, 1976-2 C.B. 345, if made effective, would require the tire industry to implement new tire pricing structures, dealer contracts, warranty adjustment forms, computer programs, accounting procedures and a number of other wasteful and otherwise unnecessary administrative requirements, while having the potential for introducing inconsistencies in the imposition and administration of the excise tax.

C. S. 2904 would simplify the excise tax laws by rendering unnecessary the extensive documentation and administrative difficulties of the present system.

1. Subject to a two-year transition period designed to neutralize the revenue effects of shifting from present laws to the simpler system under S. 2904, it would deny manufacturers the present credit or refund of excise tax when a tire fails to give normal use and a warranty adjustment is made.

2. It would provide an equivalent overall adjustment in the excise tax which reflects general warranty adjustment experience for tires.

3. The legislation will eliminate numerous administrative problems, both as to the tire industry and the Internal Revenue Service, on an essentially revenue-neutral basis.

4. The legislation is supported by the Treasury Department.

D. We urge the prompt enactment of S. 2904.

STATEMENT BY
MALCOLM R. LOVELL, JR., PRESIDENT
RUBBER MANUFACTURERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

August 4, 1980

I am Malcolm R. Lovell, Jr., President of the Rubber Manufacturers Association, representing here today the United States tire manufacturing industry. Our members have tire manufacturing facilities in 24 states and, when office and sales facilities are considered, are in active business in all 50 states. I am pleased to have this opportunity to appear before the Subcommittee to state the industry's strong support for S. 2904. S. 2904 would simplify existing law by eliminating--on an essentially revenue-neutral basis (after the necessary transition period)--a series of thorny administrative problems under the Federal excise tax on tires, which have plagued both the industry and the Internal Revenue Service since the early 1970's.

The subject matter of the bill should be familiar to the Committee, since prior bills directed to the same problem in the 95th and 94th Congresses were favorably acted upon by the Committee, the House, and by the House Ways and Means Committee, and would apparently have been enacted, but for having been reported out so close to adjournment. Although the prior bills were not opposed by the Treasury Department, S. 2904 was prepared as a new approach at the affirmative suggestion of Treasury and has been brought forward with its support. Given the urgent need for action explained below, we hope that this joining by the industry in the Treasury proposal will now permit the swift adoption by the Congress in this Session of the definitive legislative solution embodied in this bill.

Specifically, S. 2904 would simplify the manufacturers excise tax laws on tires by removing Internal Revenue Service regulation from tire warranty adjustment procedures involving manufacturers at both the dealer and consumer levels, by--

1. denying to manufacturers a credit or refund of excise tax (hitherto administratively allowed) where a tire fails to give normal use and a warranty adjustment is made;
2. providing an equivalent overall adjustment in the excise tax rate, this reduction reflecting general warranty adjustment experience for tires; and
3. maintaining for the necessary two-year transitional period (from enactment) the tire excise tax warranty adjustment procedures used administratively for almost 50 years, thereby avoiding a requirement for two administratively costly transitions in a brief period.

The two-year transition period has been designed so that manufacturers on an overall basis should come out approximately even on adjustments given and received through the period needed to shift from present laws to the simpler system under S. 2904.

Warranty adjustment procedures under the tire excise tax were administratively adopted in 1932, and have been developed further in a number of published and private rulings of the Internal Revenue Service, most notably Rev. Rul. 59-394, 1959-2 C.B. 280. Complex systems of tire distribution evolved to meet various industry needs, in the process relying upon the established tire excise tax procedures. Details vary at the wholesale level, but the consumer is nonetheless generally entitled to present a tire for warranty adjustment anywhere the same tires are sold in the United States, irrespective of the place of original

purchase. If, for example, the tire has rendered only 40 percent of the normally anticipated service (typically measured by tread wear), then the consumer receives a refund or credit of 60 percent of the retail price of the replacement tire, together with 60 percent of the associated federal excise tax.

Present law (Section 4071 of the Internal Revenue Code of 1954, as amended) imposes a manufacturers excise tax on tire manufacturers at the rate of 10 cents per pound on new tires and tubes of the type used on highway vehicles, and 5 cents per pound on tread rubber and tires of the type used on nonhighway vehicles. The administratively adopted credit or refund is then available to the manufacturer where the sale of a new tire is later adjusted under a warranty as just described. Roughly $20,000,000 in excise tax warranty adjustment credits or refunds are made annually in the United States, and for ordinary passenger tires, the individual excise tax credits or refunds are typically small, often between $1.00 and $2.00. Extensive documentation from the consumer/distributor/manufacturer levels to the Service is nonetheless required in support of each credit or refund allowed.

Although the warranty adjustment procedures were originally adopted administratively (Rev. Rul. 59-394, 1959-2 C.B. 280; S.T. 644, C.B. XII-1, 381 (1933)), they worked well for many years. In the early 1970's, however, a number of questions as to the proper method of computing total adjustments under Rev. Rul. 59-394 were raised upon audit. After these interpretive questions emerged, the Service announced major changes in the mechanics of tire excise tax warranty adjustment procedures in Rev. Rul. 76-423, 1976-2 C.B. 345. The changes proposed by Rev. Rul. 76-423 should have had no revenue effect, and were evidently designed to achieve the theoretical goal of aligning the weight-oriented tire tax procedures with procedures under ad valorem excise taxes.

To comply, the tire industry would have been required to implement new tire pricing structures (for unadjusted as well as adjusted tires), new dealer contracts, new warranty adjustment forms, new computer programs and accounting procedures, new directives and training materials, and new informational materials to educate the general public. Perhaps worse than this onerous and purposeless additional administrative burden created by the Service, Rev. Rul. 76-423 had the potential for introducing the very inconsistencies in excise tax administration (based on mechanical differences in distribution procedures) which Congress said should be avoided when the manufacturers excise taxes were originally enacted in 1932. H.R. Rep. No. 708, 72nd Cong., 1st Sess. (1932), reprinted in 1939-1 (Part 2) C.B. 457, 480. Although its effective date was twice postponed, Rev. Rul. 76-423 remains outstanding, is viewed by the tire industry as of doubtful validity, and would in any event be disruptive and administratively costly to implement.

S. 2904 would render unnecessary this wasteful administrative exercise, since Rev. Rul. 76-423 would not be permitted by the bill ever to have operative effect. Since the excise tax consequences of warranty adjustment transactions would be identical under all methods of tire distribution, S. 2904 would also solve the current problems by returning to the originally expressed Congressional intent:

> "It is of utmost importance that the tax be imposed and administered uniformly and without discrimination. Each member of a competitive group must pay upon substantially the same basis as all his competitors, even though his sales methods may differ." H.R. Rep. No. 708, 72nd Cong., 1st Sess. (1932), reprinted in 1939-1 (Part 2) C.B. 457, 480.

In conclusion, S. 2904 is a sound solution to currently pressing excise tax administrative problems, would simplify the tax laws on an essentially revenue-neutral basis and bring about greater uniformity of treatment, is supported by both industry and the Treasury Department, and the Rubber Manufacturers Association therefore urges its immediate enactment.

Senator BYRD. Next will be a panel to discuss S. 2775, which was introduced by Senator Bentsen, Mr. Edwin S. Cohen, Foreign Pension Plan Task Force, and a former Assistant Secretary of the Treasury. We are glad to have you, Mr. Cohen. Mr. Jerry L. Oppenheimer, ERISA Industry Committee; and John F. Abel, Towers, Perrin, Forster & Crosby, a pension consulting firm.

I assume, Mr. Cohen, you want to proceed.

STATEMENT OF EDWIN S. COHEN, FOREIGN PENSION PLAN TASK FORCE, ACCOMPANIED BY JERRY L. OPPENHEIMER, ERISA INDUSTRY COMMITTEE AND JOHN F. ABEL, TOWERS, PERRIN, FORSTER & CROSBY

Mr. COHEN. Thank you, Mr. Chairman.

I shall be brief in view of the fact that Mr. Halperin, on behalf of the Treasury here today, said that the Treasury had no objection to the bill. I would just like, if I may, to describe the subject with which it deals, and to make two points.

I am Edwin S. Cohen. I am a member of the law firm of Covington & Burling, and I appear this morning on behalf of the Foreign Pension Plan Task Force in support of S. 2775 introduced by Senator Bentsen, and cosponsored by six other members of the Committee on Finance.

With me this morning are Mr. Jerry L. Oppenheimer, on my right, a member of the law firm of Mayer, Brown, & Platt, who represents the ERISA Industry Committee, comprised of more than 100 employers, most of which maintain employee benefit plans overseas, and Mr. John F. Abel, vice president and manager of the international department of the pension consulting firm of Towers, Perrin, Forster & Crosby, which was instrumental in organizing our task force. Our task force consists of more than 20 corporations which maintain foreign pension plans.

Many U.S. companies that do business outside the United States through foreign branch offices or foreign subsidiaries maintain pension and similar employee benefit plans for their employees at the foreign locations, just as they maintain such plans in the United States for American employees. Substantially all the participants in these foreign plans are nonresident aliens of the United States.

The pension plans that are established overseas for the employees abroad must necessarily conform to the laws and requirements of the foreign countries, but those foreign requirements and practices are often different from those prescribed in ERISA and the Internal Revenue Code. Nevertheless, the IRS has recently taken the position that for U.S. income tax purposes the employers' foreign pension plans must conform to ERISA and the Internal Revenue Code.

In the view of the IRS, the employers would be required to conform the pension plan to the U.S. rules of ERISA even though that might be impossible because of contravening the laws of the foreign government or requiring the payment of higher foreign taxes by the employer or the employees, or both. This creates for the employer an obvious dilemma which the Service indicates it cannot alleviate and which Congress alone may remedy.

This bill seeks to remedy this situation by prescribing rules that would have to be followed by the U.S. employer with respect to his foreign pension plan, and those rules would not contravene the laws and requirements of the foreign governments.

Mr. Chairman, we are pleased that the Treasury indicated this morning that it had no objection to this bill. There are two brief comments that I would like to make.

The first is that the bill does not contain an effective date provision. We believe that an effective date provision should be inserted. Mr. Halperin indicated this morning that the Treasury would have no objection to the bill applying retroactively, at least with respect to foreign subsidiaries, and we think that this should be the case also with respect to foreign branches.

Second, the Treasury in its written statement called attention to two additional problems relating to foreign subsidiaries which it thought the joint committee staff should give further consideration to for the purpose of proposing additional legislative proposals.

We have no objection to that, and we will be happy to cooperate in a study of those matters. We think that they relate to matters generally and not to the specific problem of foreign pension plans; because of the dilemma that is faced by these companies and that would be remedied by this bill, we would urge that this bill be acted upon by the committee, and not delayed until these other general matters can be studied. We do not believe that there would be sufficient time in this Congress to consider the broader matters which are not specifically related to this issue that the Treasury has called attention to in its statement.

We would urge the committee to move to enact this particular bill in this session.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir.

Mr. Oppenheimer?

Mr. OPPENHEIMER. Mr. Chairman, in order to conserve the committee's time, we have agreed that Mr. Cohen would make our principal statement. I merely endorse what he has to say on behalf of the ERISA Industry Committee. I would be prepared to answer any questions.

Senator BYRD. Thank you, sir.

Mr. ABEL. I am in exactly the same position. I support Mr. Cohen's position completely, and I would be glad to answer any questions if there are any.

Senator BYRD. Thank you very much.

Let me ask you this—Why are the companies with foreign pension plans suddenly requesting that the plans be exempted from ERISA; should not this have been done when ERISA was originally enacted?

Mr. COHEN. Mr. Chairman, when ERISA was enacted it specifically provided that the labor provisions of the law would not apply to foreign plans, and that the pension plan guarantee provisions would not apply, but nothing was said with respect to the tax provisions.

It is our view that the same principle should apply with respect to the tax provisions, and I understand the Treasury agrees with us from the statement that they have made.

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The IRS, however, says that the absence of a provision in the law making the same statement with respect to taxes that was specifically made with respect to the labor law provision and the pension guarantee provision forces them to take the position that the tax credits and deductions of these plans cannot be allowed unless they conform to the American law, even though that law is different from the foreign law. In many cases the firm cannot comply with both laws simultaneously.

Senator BYRD. As I understand it, ERISA prohibits companies from using pension funds as part of the retained capital of a company. Other nations, particularly Germany, I understand, require such action.

Mr. COHEN. Yes.

Senator BYRD. That is one example of why something needs to be done.

Mr. COHEN. That is precisely one of the cases that is significant here.

Senator BYRD. Which is the better way to handle it, as the United States handles it, or as Germany handles it?

Mr. COHEN. There are arguments to be made on both sides, Mr. Chairman. We have stated in the Internal Revenue Code that, for the benefit of the employees, the funds should be segregated from the assets of the employer, so that the funds would be set aside for the employees. Even though we have done that, we have had problems that led to ERISA, where the funds were not there when employees reached retirement age. So we have provided a variety of rules, including the Pension Plan Guaranty Corp.

On the other hand, we could have another set of rules in which the funds are left in the hands of the employer, for the employer to use, but the obligation to the employees would be governed by other legal requirements. If you have a different legal system for the support of the employees, you would not have to require that the assets be segregated.

It depends on your total legal system that protects and benefits employees. But our problem is that if another country has considered all the pros and cons in designing its system to protect its workers, and has decided upon a different system, it is pointless to say to American companies that because you are American companies, you must comply with the American law as well as with the foreign law when that cannot be done.

For example, in the case of some of these foreign countries, if the country permits segregating the assets in a separate fund, then the foreign country will say that the employee must pay tax on those amounts currently. So even though the employer might be free to put the money into a separate trust for the benefit of the employee, the employee would not want to have that done for his benefit if he had to pay tax currently on it.

Senator BYRD. That would be very disadvantageous.

Mr. COHEN. That is the problem that we face.

Senator BYRD. Thank you very much.

[The prepared statements of Messrs. Cohen, Oppenheimer, and Abel follow:]

SUMMARY OF THE PRINCIPAL POINTS
IN THE STATEMENT OF EDWIN S. COHEN BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
IN SUPPORT OF S. 2775

AUGUST 4, 1980

1. Many U.S. companies that do business outside the United States through foreign branch offices or foreign subsidiary corporations maintain pension and similar benefit plans for their employees. Substantially all of the participants in these foreign pension plans are nonresident aliens of the United States, and the plans are typically subject to rules and restrictions prescribed by foreign law.

2. The Internal Revenue Service has recently taken the position that for U.S. income tax purposes the employer's foreign pension plan must conform to U.S. rules that were designed for domestic plans, even though the U.S. rules may be inconsistent with the applicable foreign rules.

3. The Service's attempt to extend the application of U.S. pension policy to foreign pension plans maintained primarily for nonresident aliens is questionable as a matter of law, unwise as a matter of tax policy and would lead inevitably to protracted litigation.

4. S. 2775 would provide a single set of specific rules for the treatment of pension expenses of both foreign branches and foreign subsidiaries in lieu of applying the detailed U.S. rules that were designed for domestic plans. It would -

- remove an unfair and unwarranted burden and dilemna for U.S. companies that provide pension plans for foreign employees;

- relieve the Service and employers of the unmanageable burden of determining whether foreign pension plans qualify under ERISA as well as under foreign law; and

- eliminate the need for lengthy litigation to determine the precise applicability of U.S. pension rules to foreign pension plans.

STATEMENT OF EDWIN S. COHEN
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
ON S. 2775

AUGUST 4, 1980

My name is Edwin S. Cohen. I am a member of the law firm of Covington & Burling and I am appearing this morning in support of S. 2775 on behalf of the Foreign Pension Plan Task Force. Accompanying me are Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, who represents the ERISA Industry Committee (ERIC), which is comprised of more than 100 major employers, most of which maintain employee benefit plans overseas; and John F. Abel, Vice President and Manager of the International Department of the international pension consulting firm of Towers, Perrin, Forster & Crosby, which was instrumental in organizing the Foreign Pension Plan Task Force. That Task Force consists of more than 20 corporations which have foreign pension plans.

In response to the Chairman's request that commonly interested groups designate a single spokesman, I shall make the principal statement on behalf of the group. Mr. Oppenheimer and Mr. Abel are available to answer questions. In addition, members of the Task Force and others may file statements for the record.

I. Background

Many U.S. companies that do business outside the United States through foreign branch offices or foreign

subsidiary corporations maintain pension and similar benefit plans for their employees at the foreign locations just as they maintain pension plans in the United States with respect to their employees located here. Substantially all of the participants in these foreign plans are nonresident aliens of the United States, and the plans are typically subject to rules and restrictions prescribed by foreign law, including foreign income tax law. Although it is permissible in some countries to fund part or all of a pension or similar benefit plan through contributions to a trust or similar funding vehicle, this is not normally required. Indeed, some countries, such as Germany and Japan, even tax the employees currently on part or all of their future pensions if they are funded in a pension trust of the type we generally have in the United States. Instead, employers are permitted and, in some countries, encouraged to accrue the pension liability on their books as pension reserves. These accruals of pension liabilities are generally deductible under the foreign country's income tax law if the particular pension plan requirements of the foreign country are met.

Pension and similar employee benefit plans maintained in the United States -- whether by domestic or foreign employers -- are regulated by ERISA (the Employee Retirement Income Security Act of 1974) and related provisions of the Internal Revenue Code. In order for employers to deduct the costs of their domestic pension plans on their United States income tax returns, the

plans must be "qualified" under the requirements of ERISA and the Code and funded by cash contributions to a pension trust. The pension plans established overseas for employees located in foreign countries must necessarily conform to the requirements and practices of those countries, which differ in many respects from our own rules in ERISA and the Code.

The Internal Revenue Service has recently taken the position in both a private ruling and a technical advice memorandum that for U.S. income tax purposes the employer's foreign pension plan must conform to U.S. rules. In both cases considered by the Service, substantially all of the employees covered by the plans in question were nonresident aliens, the plans conformed to the pension plan rules of foreign countries, and the expenses of the plans were deductible under the income tax laws of the host countries. In the Service's view, the employers were nevertheless required to conform the pension plans to the U.S rules even though that might be impossible because it would contravene the foreign law or would require payment of higher foreign taxes by the employer, the employees or both. This creates for the employers an obvious dilemma which the Service indicates it cannot alleviate and asserts only the Congress can remedy.

The private ruling concerned a pension plan maintained by a foreign branch of a U.S. corporation in a foreign country. The Service took the position that because the pension plan requirements of the Code were not fully met, the contributions to the pension trust were not deductible for U.S. income tax

purposes either at the time they were paid by the employer to the trust or at the time that the benefits were actually paid by the trust to the participants and beneficiaries.

The technical advice memorandum involved the foreign subsidiary of a U.S. corporation. In accordance with local law and practice, the subsidiary reflected its pension liability to its employees by an annual accrual in a pension reserve. It did not fund the plan through contributions to a pension trust, as would be required of a qualified plan under ERISA. The Internal Revenue Service concluded that the foreign subsidiary could not reduce its earnings and profits by the amount of its properly accrued pension plan expense liability. This failure to recognize the foreign subsidiary's legitimate pension expenses would result in an unwarranted increase in the U.S. parent corporation's net U.S. tax liability on dividends received from its foreign subsidiary.

II. Extension of U.S. Social Policy To Foreign Plans

The Service's attempt to extend the application of U.S. pension policy to foreign pension plans maintained primarily for the benefit of employees who are nonresident aliens is questionable as a matter of law, unwise as a matter of tax policy and would lead inevitably to protracted litigation.

A. Statutory Authority

In the case of a foreign branch of a U.S. company, the deductibility of its pension expenses directly affects the

company's U.S. tax liability. There is no express exemption from the provisions of ERISA for plans maintained by branch operations. While there were difficulties in qualifying a foreign pension plan for U.S. tax purposes prior to the enactment of ERISA, qualfying such plans is virtually impossible under ERISA. Foreign plans maintained primarily for non-resident alien workers are expressly exempt from the labor law provisions of Title I of ERISA and the termination insurance provisions of Title IV. The legislative history of ERISA does not suggest an affirmative Congressional intention to subject such plans to the tax provisions of Title II, although Title II contains no express exemption for them. The application of the ERISA provisions to such plans makes it difficult, more costly in terms of foreign taxes and, in some cases by reason of contrary foreign law requirements, literally impossible to qualify a foreign pension plan for purposes of U.S. tax law.

There is even less basis in law for applying the U.S. tax deduction rules to the pension expenses of foreign subsidiary corporations. Since those corporations are not U.S. taxpayers, they do not claim deductions for their pension expenses. Their pension expenses are relevant to U.S. tax law only insofar as they reduce the corporation's earnings and profits. If the foreign corporation pays dividends to its U.S. parent corporation and the pension expense does not reduce its earnings and profits, the amount of foreign tax paid that is available for credit against the U.S. tax on

the dividends will be artificially reduced. Earnings and profits is essentially an economic measure of a corporation's ability to pay dividends. Where a foreign corporation's pension expense represents a bona fide liability that would reduce the amounts available for the payment of dividends, it should reduce the corporation's earnings and profits. This has been the consistent and long-standing practice in this area, a practice that had not been questioned prior to the recent issuance of the technical advice memorandum by the Service.

B. Policy Considerations

The Service's interpretation of the current law is based on the notion that ERISA requires the Service to enforce the United States' pension laws outside this country for the benefit of foreign workers even where the foreign government has different rules which at times conflict with our own. Our pension rules are the embodiment of a social policy reflecting historical, economic and social factors that, in combination, are unique to the United States. Other countries with different circumstances have taken other approaches that best meet their particular needs. Although many would acknowledge that our policy is a good one that has served us well, no one would suggest that it is the only rational means of providing retirement security to workers. In the absence of a universally acknowledged "correct" pension system, a conclusion that

ERISA requires the United States to export its pension rules is disruptive to the conduct of American business abroad and places U.S. companies doing business abroad in an untenable position.

As I have noted, in some instances the requirements of foreign law are flatly irreconcilable with those of ERISA. For example, under Canadian law, in order to qualify a retirement plan that provides benefits in the form of a life annuity, the plan must provide that a retiring employee will receive the benefits in the form of a single life annuity unless the employee chooses another form. In contrast, under U.S. law, if a plan provides benefits in the form of a life annuity, in order to qualify it must provide married employees with a joint and survivor annuity for the lives of the employee and the employee's spouse unless the employee chooses to receive the annuity in a different form. Though as a practical matter the difference between the U.S. and Canadian rules seems minor, it is not possible for the employer to comply with both rules simultaneously.

In other cases foreign law makes the cost of complying with U.S. pension law prohibitive. For example, the German government has created tax incentives for retaining assets in productive use in business, and this is the overwhelming practice of employers in that country. Consequently, for German income tax purposes employers may accrue as deductions the current addition to reserve for their pension plans.

However, if they contribute assets to a funding vehicle, either the tax deduction to the employer is severely restricted or the employees are charged with current taxable income.

These examples illustrate that U.S. companies doing business abroad cannot reasonably be asked to revise their foreign plans to comply with U.S. pension law and still conform to the pension law and practices of the foreign host country. We think that, in determining U.S. tax consequences, it is inappropriate and unfair to ignore the legitimate pension costs associated with doing business abroad where the host country has chosen to provide retirement security rules for its workers under a system different from our own.

III. Overseas Effect

Deferring to foreign pension rules would not deprive foreign workers of reasonable pension benefits and safeguards for those benefits. The majority of U.S.-owned overseas businesses are situated in the industrialized countries of the world -- primarily the countries of western Europe, Japan and Canada. These countries have developed pension systems that provide adequate retirement security for their citizens. Differences in history, legal structure, and culture have, in some instances, produced pension systems that provide even broader benefits than our system does. For example, whereas employers in the United States are free to choose whether or

not to establish a pension plan and what level of benefits to provide, in Italy and numerous other countries every employer is required by statute to pay its employees upon retirement a severance indemnity of a specified amount based upon years of service. However, the practice in most of these countries is not to set funds aside in a separate trust, and, indeed, under the law of many of these countries trusts or similar funding vehicles are unknown. A U.S. company doing business in Italy would not be able to deduct the accrued cost of its severance indemnity plan under the Internal Revenue Service's interpretation of current law even though the cost is deductible for Italian income tax purposes. Likewise, an Italian subsidiary of a U.S. company would not be able to reduce its earnings and profits on account of its accrued severance indemnity expenses.

IV. S. 2775

To clarify this situation and to eliminate the problems raised by the Service's rulings, S. 2775 would provide a single set of specific rules for the treatment of pension expenses of both foreign branches and foreign subsidiaries in lieu of applying the detailed rules of ERISA that were designed for domestic plans. Briefly stated, under the bill the annual cost of a foreign plan would be taken into account for U.S. tax purposes only if the plan were either required by foreign law or announced to the employees, and then only to the extent that either amounts are contributed

to an irrevocable trust for the benefit of employees or the employees' benefits are not subject to a substantial risk of forfeiture. The amount of the annual pension cost that can be taken into account would in all events be limited to amounts determined under generally accepted U.S. accounting principles.

The provisions of S. 2775 would be applicable only in the case of pension plans substantially all of whose participants are nonresident aliens. Moreover, the employer would in any event not be entitled to take into account under S. 2775 that proportion of its cost for the foreign plan, above a _de minimis_ level, attributable to benefits for U.S. workers participating in the plan.

S. 2775 would also amend section 679 of the Code to insure that income earned by a trust under a funded plan primarily for the benefit of nonresident aliens would not be taxed to the employer.

The effective date of the provisions of S. 2775 are not stated. In the case of foreign branch operations of U.S. companies, the problem caused by the asserted need to comply with U.S. pension law is largely attributable to the failure of ERISA to provide adequate rules regarding foreign pension plans. Therefore, in order to fill that gap the effective date of the provisions applicable to foreign branches should relate back to the date of ERISA's enactment.

As applied to foreign subsidiaries, this bill would clarify and add specific rules to existing law without making

any fundamental change. In the interest of avoiding protracted litigation with respect to past years, these provisions should be made effective in the case of foreign subsidiaries for all past years.

On June 26th, at the hearings held before the House Subcommittee on Select Revenue Measures, the Treasury Department expressed its general support for H.R. 7263, which is identical with S. 2775. At those hearings, the Treasury expressed the view that since the earnings and profits of foreign corporations generally follow the normal U.S. rules governing the calculation of taxable income, an amendment to section 312 would be unnecessary. At the same time, the Treasury stated that it had no objection if the provisions of the bill were made applicable retroactively for the purpose of calculating the earnings and profits of foreign subsidiaries.

Although we prefer the amendment to section 312 that would be made by both H.R. 7263 and S. 2775, we would not oppose deleting the amendment to section 312, as long as the bill's effective date provisions specifically state that the bill governs the computation of the earnings and profits of foreign subsidiaries and that, for this purpose, the bill will be applicable retroactively to all taxpayers electing to be subject to its provisions.

The effective date of the amendment to section 679 of the Code should conform to the effective date of that section.

V. Conclusion

Enactment of S. 2775 would remove an unfair and unwarranted burden and dilemma for U.S. companies that provide pension plans for foreign employees; it would relieve the Service and employers of the unmanageable burden of determining whether foreign pension plans qualify under ERISA as well as under foreign law; it would eliminate the need for lengthy litigation to determine the precise applicability of U.S. pension rules to foreign pension plan; and it would provide a clear tax rule that would enable the business community to plan effectively for the foreign pension programs.

August 4, 1980

STATEMENT OF

JERRY L. OPPENHEIMER

ON BEHALF OF

THE ERISA INDUSTRY COMMITTEE (ERIC)

BEFORE THE SUBCOMMITTEE ON

TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

REGARDING

S. 2775

Summary

S. 2775 should be enacted promptly.

It would clarify the tax treatment of contributions to plans maintained primarily for the benefit of nonresident aliens by generally conforming the tax treatment to the present treatment of those plans under Titles I and IV of ERISA.

It would resolve uncertainty, eliminate unintended results, and reduce conflicts between U.S. and foreign laws.

Mr. Chairman, I am Jerry L. Oppenheimer, a member of the law firm of Mayer, Brown & Platt, here in Washington. I appear today on behalf of The ERISA Industry Committee (ERIC), an association of some 100 major employers, most of which maintain employee benefits plans for nonresident aliens.

ERIC strongly urges prompt enactment of S. 2775. It would resolve uncertainty, eliminate unintended results, and reduce conflicts between U.S. and foreign laws. It would clarify the tax treatment of contributions to plans maintained primarily for the benefit of nonresident aliens by generally conforming the tax treatment to the present treatment of those plans under Titles I and IV of ERISA.

U.S. employers doing business abroad customarily maintain retirement and similar plans for the benefit of nonresident aliens. Contributions to these plans are clearly business expenses, and S. 2775 would remove any doubt that employers may deduct contributions to them in the case of foreign branch plans or, in the case of foreign subsidiary plans, take the contributions into account in determining earnings and profits.

To protect U.S. workers, ERISA added many new social policy judgments in the form of new Code requirements. These requirements have no relevance to foreign plans and frequently conflict with the law and policy of the host country. Indeed,

plans "maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens" are presently exempt from Titles I and IV of ERISA.

Nevertheless, in private letter ruling 7904042, the Service held that a U.S. employer may deduct contributions to a foreign defined benefit plan only if the plan complies with all of the ERISA amendments to the Code, even if it is impossible to comply because of directly conflicting foreign requirements.

Similarly, in Technical Advice Memorandum 7839005, the Service suggests that a U.S. employer cannot take into account accumulations under a German plan for purposes of determining earnings and profits, unless the German plan meets the requirements applicable to a domestic plan, including the ERISA requirements.

The U.S. tax treatment of contributions to plans maintained primarily for nonresident aliens should not depend upon whether the plans meet ERISA standards. The ERISA Conference Report suggests that the Code does not specifically deal with foreign plans because "such plans would have no need to seek tax deferral qualification". H.R. Rep. 93-1280, 93 Cong., 2d Sess. 291 (1974). Upon reflection, this explanation is at best incomplete; it ignores the tax treatment of contributions to these plans and fails to recognize that they often cannot be made to comply with ERISA's requirements. We believe strongly

that had there been the time to focus fully on the matter when ERISA passed, Congress would have then adopted provisions similar to those now embodied in S. 2775.

The bill would also clarify that a U.S. employer is not taxable on the income of a foreign plan merely because it fails to meet ERISA's requirements. While we know of no case where the Service has attempted to tax an employer on the income of a pension plan maintained for nonresident aliens, any possible ambiguity should be resolved.

The bill as introduced does not include any specific effective date. It would clarify the treatment afforded to foreign subsidiary plans by adding new requirements but without making fundamental changes. Thus, any amendment with regard to subsidiaries should apply to all years.

Let me note, however, that the Treasury Department has indicated with respect to H. R. 7263 (which is the companion bill to S. 2775) that it does not believe that an amendment regarding foreign subsidiaries is necessary but that if any such amendment is adopted, the Treasury has no objection to its retroactive application. ERIC would not oppose deletion from S. 2775 of the proposed foreign subsidiary amendment if it were specifically provided that the bill governs computation of earnings and profits of foreign subsidiaries and that, for this purpose, the bill will be applicable retroactively to any taxpayer electing to be subject to its provision.

We also view the legislation as essentially removing any doubt regarding the proper application of ERISA to foreign branch plans, and we strongly suggest that the effective date regarding branch plans should be consistent with the effective date of ERISA.

The amendment regarding taxation of the income of foreign plans is also designed to remove any doubt regarding proper application of the Code, and the amendment's effective date should conform to the present effective date of the section in question.

We appreciate the opportunity to appear in support of S. 2775, and strongly urge its prompt enactment. I will be happy to answer any questions.

STATEMENT OF

John F. Abel

before

Subcommittee on Taxation and Debt Management Generally
Finance Committee
United States Senate
Regarding
S. 2775
August 4, 1980

My name is John F. Abel. I am Vice President and Manager of the International Department of Towers, Perrin, Forster & Crosby, Inc. On behalf of my organization and a group of more than twenty major corporations, I support S. 2775 and respectfully urge this Subcommittee to report it out favorably at the earliest possible date.

Towers, Perrin, Forster & Crosby, Inc. is an organization of management consultants specializing in human resource, actuarial, and selected general management services on a world-wide basis. For more than sixty years, we have been assisting corporate management in a variety of business-related matters. We maintain a professional consulting and support staff of more than 950 people and serve more than 3,000 clients. Of these, more than 500 are companies that do business in more than ninety countries. We employ more than 175 actuaries. Our comments reflect the experience we have gained in tailoring pension and other benefit plans to suit the needs of our diverse group of clients in the United States and abroad.

TPF&C has been working with a group of more than twenty companies that are concerned about the uncertainties governing the tax treatment in the United states of contributions made by employers to foreign pension and similar plans. We also maintain pension plans in six other countries for our employees located in those countries.

It is on behalf of these companies, as well as my own firm, that I support enactment of S. 2775.

I wish to share with you the kinds of problems a typical corporation faces in its effort to manage these types of programs in several different countries. Such a company has to comply with all local laws as they may be modified from time to time. It needs to know in an unambigous manner how the contributions made and the reserves established under pensions or similar programs in these countries are to be treated under United States tax laws.

Let me briefly describe the types of legal requirements and customary local practices that an employer must confirm with in maintaining its pension plans in three major industrial countries. We will take Germany, France, and the United Kingdom as examples. This should place the potential nondeductibility of such pension costs in better perspective.

Germany

Plans providing retirement income to supplement Social Security are wide-spread in Germany. Typically, these plans are financed by company-held reserves, rather than through contributions to a trust fund as in the U.S. Funding as we know it is in fact discouraged by being given less favorable tax treatment and can result in immediate taxation to the plan's beneficiaries.

Vesting schedules under German plans differ from the 10-year cliff vesting schedule most common in large U.S. pension plans. In Germany vesting is required after either attainment of age 35 and completion of ten years of participation or attainment of age 35 and three years of participation with 12 years of service.

Liabilities under book reserve arrangements are calculated in accordance with German tax law using a uniform prescribed method and set of assumptions. This is designed to restrict the tax deduction rather than reflect the true economic picture of the pension plan and the company. The combination of tax law, labor law, obligations law and reinsurance provisions makes an employer's pension promise virtually an irrevocable liability, and employees also receive assured benefit protection under a program analagous to plan termination insurance in the United States.

To attempt to conform such a German plan to U.S. law requirements for funding, vesting, participation, benefit accruals, and joint and survivor benefits would make it unrecognizable in comparison to plans maintained by local German employers. It would result in a plan that varied from comparable local plans for reasons that would be irritating to the German government and socially inexplicable to German employees. Moreover, it could require increased costs on the part of the U.S. employer, e.g., through paying higher German taxes.

France

Pension plans in France are quite different still from those in both the U.S. and Germany.

Basic social security benefits are supplemented by compulsory pensions provided through multiemployer pension systems covering groups of employees. Two important systems are ARRCO, covering all employees, and AGIRC, covering essentially "exempt" employees. These systems provide a range of retirement and survivor pensions. Both employers and employees are required to make contributions. Most companies provide supplementation through the multiemployer pension system. Private pension plans supplementing the compulsory systems are not common.

As for funding, the system operates on a pay-as-you-go basis with contribution levels basically fixed, subject to minor variations. Typical total contributions involving employees and employers are 6.4% of pay at ARRCO and 16.48% (maximum rate) at AGIRC.

Vesting is full and immediate in accrued "pension points" based on the percentage of employer and employee contributions to the plan. Pensions are indexed in line with general salary increases.

Again, it can be seen that the local benefit practices are far different from those in the U.S., cannot be ignored by companies operating in France, and the U.S. tax consequences of contributions to these plans should be clear.

United Kingdom

Practices in the United Kingdom are closer to those in the U.S. than in France or Germany, but still somewhat at variance.

In addition to basic Social Security benefits, the U.K. also requires a minimum "earnings-related pension scheme", as it is called there. Employers that "contract in" pay premiums to the scheme and may establish a supplementary pension plan that integrates with that scheme.

Employers that "contract out" must provide the minimum level of benefits and then may provide a supplementary plan.

Plans providing retirement income and other benefits over and above the minimum required are virtually universal in this country. And, while they are typically financed on an advance-funded basis by contributions to trust funds or insurance companies, U.K. practices may differ in other respects, such as providing different types and amounts of death benefits than those customarily found in U.S. plans or in integrating with Social Security.

Full vesting is required after attainment of age 26 and 5 years of service.

Thus, these three countries illustrate the difficulties of maintaining pension or similar benefit plans in several countries. One country (France) mandates both the benefit provisions and the funding method; one (U.K.) encourages the type of funding with which we are familiar but has different requirements for benefits amounts; in the third (Germany), the government prescribes the amount which may be deducted for local tax reasons. Other countries have other practices and requirements.

These examples give you a flavor of the wide variations that abound through the nations of the world with respect to pensions and similar programs. In many countries, benefits are legally required; in many countries funding facilities as known in the U.S. are unavailable or the type of funding is mandated as well. The Western industrialized nations all have established social security systems and tax and funding rules for private plans which supplement those systems. And in other countries the governmental regulations control the payment of benefits granted or required.

There are wide variations in types of benefits required from country to country. But, in most foreign countries, there are some kind of benefits -- defined contribution plans or defined benefit plans -- which an employer for one reason or another must adopt. As mentioned at the beginning of my remarks, it is necessary that the employer have a clear understanding of how the amounts contributed to such plans will be treated for U.S. tax purposes and it is for this reason that we strongly support this bill.

I would be glad to answer any questions about foreign plans.

Thank you.

Senator BYRD. Next will be a panel dealing with H.R. 7171, Mr. Dan L. Kiley, vice president, taxation, Norfolk & Western Railway Co.; Mr. David Challoner, dean, St. Louis School of Medicine; and Mr. Robert Haldeman, trustee, Lehigh Valley Estate.

I understand that Mr. Kiley will deal with section 4, Mr. Challoner, with section 1, and Mr. Haldeman, with section 5.

STATEMENT OF DAN L. KILEY, VICE PRESIDENT, TAXATION, NORFOLK & WESTERN RAILWAY

Mr. KILEY. Thank you, Mr. Chairman.

Following your statement earlier to be brief, and since Treasury does not oppose section 4 of H.R. 7171, I request that my prepared statement be made a part of the record.

Senator BYRD. It will be made a part of the record.

Mr. KILEY. Thank you, sir.

I would also remind the committee that I testified with respect to this subject on November 7, 1979, in connection with H.R. 2797.

I will be pleased to answer any questions.

Senator BYRD. Thank you, sir.

[The prepared statement of Mr. Kiley follows:]

Statement of Daniel L. Kiley
Submitted to the
Subcommittee on Taxation
and Debt Management Generally
of the Committee on Finance
United States Senate
August 4, 1980

Re: Section 4, H.R. 7171

Section 4 of H.R. 7171 addresses a problem which has arisen in the interpretation of Section 374 of the Internal Revenue Code which covers the tax treatment of exchanges under the Final System Plan pursuant to the Regional Rail Reorganization Act of 1973 ("3R Act"). Section 374 provides that no gain or loss is recognized when, in order to carry out the Final System Plan, rail properties of a transferor railroad are transferred to Conrail.

In both 1976 and 1978 Congress recognized that under the 3R Act the tax treatment accorded conveyances to Conrail should be deferred pending the determination of value to be made by a Special Court created by the 3R Act to establish the value. That legislation provided that payment was to be made for the "constitutional minimum value" of the conveyed properties as determined in proceedings before the Special Court with appeal, if required, to the Court of Claims under the Tucker Act. Enactment of Section 374(c) in 1976 established rules for the tax consequences resulting from the deferral of the determination of the final consideration for properties transferred under the 3R Act. Section 374 also provides for preservation of net operating losses pending final determination of amounts to be awarded under the plan.

Legislative history is replete with indications that the intent was to defer the tax consequences of the Conrail transfers

until after the determination of value. For example, the Committee Reports (H.R. Rep. 94-940) make it clear that no allocation of basis for the securities received may be made until the Special Court determination is final and direct that the Treasury issue regulations on such allocation only after that determination. The special rule that net operating losses of a transferor company are kept available until such time as the compensation is determined (Section 374(e)) recognizes that the Special Court decision could result in an award in excess of the tax basis of the transferred assets, thus producing gain.

Subsequent events require that further clarification of Section 374 now be considered. On audit of the Norfolk and Western Railway Company (NW) consolidated tax return for 1976 the Internal Revenue Service has taken the position that Section 374 provides nonrecognition treatment only to direct transferors of property to Conrail. This limitation produces a problem for NW because of its control of Erie Lackawanna Railway Company (EL), one of the transferors of property to Conrail. EL entered bankruptcy proceedings in 1972, and is currently in the process of reorganization. It is included in the NW affiliated group for federal income tax purposes.

Notwithstanding the intent of Congress to defer tax consequences pending the final determination of value, the Internal Revenue Service has taken a position with respect to this taxpayer that a determination can be made by the Revenue Agents that the stock of EL is worthless. This assertion of worthlessness hinges

on a finding by the Revenue Agents that the amount ultimately to be awarded by the Special Court to EL will be insufficient to provide value for the EL stock. This position has been taken notwithstanding the fact that the Trustees in Bankruptcy of EL are seeking a recovery in an amount clearly sufficient to pay off debt and provide value for the stock and this claim is now pending before the Special Court.

In response to a Technical Advice Request submitted to the National Office of the Internal Revenue Service, the Service has concluded that 374(c) is inapplicable and that the Committee Reports (H.R. Rep. 94-940) do not contain anything directly inconsistent with their position. The consequences of this action are to trigger an excess loss account with respect to EL and to effectively eliminate the transferor of rail properties (EL) from the consolidated tax return of its parent (NW).

To rectify this situation, we respectfully request that this committee act to clarify the Congressional intent and provide that a determination of worthlessness of the stock of a transferor railroad as defined in Section 374 may not be made for purposes of the consolidated return regulations where such a determination depends on a finding of the final value by the Special Court.

We acknowledge that the excess loss recapture regulations apply. We recognize that tax on the excess loss will be collected no later than the year the EL will be removed from the NW consolidated return. That recapture may occur as a result of several different events, including the presently proposed reorganization plan, effective

in early 1981, for EL which would provide for loss of 80 percent stock control of EL by NW. Further, the excess loss account could be triggered prior to the Special Court determination by other events such as a sale or disposition by NW of the EL stock or a reduction by the Trustees of the EL claim in the Special Court below an amount which would give value to the stock. We agree that the consolidated return regulations apply to cause a recapture in any of these situations which may occur before a Special Court determination has been made. However, recapture of the excess loss account, which depends entirely upon a finding by the Internal Revenue Service that EL stock is worthless in 1976 based upon a determination by the Revenue Agents of the final value ultimately to be decided by the Special Court under the 3R Act, is premature until such Special Court determination becomes final.

We respectfully suggest that the committee clarify Section 374 as provided in Section 4 of H.R. 7171. We think this action will carry out Congress' original intent.

Senator BYRD. The next witness.

STATEMENT OF ROBERT HALDEMAN, TRUSTEE, LEHIGH VALLEY ESTATE

Mr. HALDEMAN. Mr. Chairman, my name is Robert Haldeman, the trustee of the property of the Lehigh Valley Railroad Co., a debtor in reorganization under section 77 of the Bankruptcy Act.

The Lehigh Valley Railroad Co., along with certain other bankrupt east coast railroads, transferred substantially all of its railroad properties to Consolidated Rail on April 1, 1976. Since that date it has continued in bankruptcy.

It is anticipated, however, that the reorganization court having jurisdiction over the Lehigh Valley will render its decision concerning Lehigh Valley's plan during the latter part of 1980 or the early part of 1981.

The purpose of the statement before your subcommittee is to propose an amendment to section 5 of H.R. 7171 which would eliminate the inequitable treatment accorded Lehigh Valley Railroad Co. in relation to the Erie Lackawanna Railway Co. under present H.R. 7171.

I have with me today Sheldon M. Bonovitz, a tax partner in the law firm of Duane, Morris & Heckscher of Philadelphia, the Lehigh Valley's general counsel. He will discuss the technical provisions and the basis for our proposed amendment.

Thank you.

STATEMENT OF SHELDON BONOVITZ, ON BEHALF OF THE LEHIGH VALLEY RAILROAD CO.

Mr. BONOVITZ. Thank you, Mr. Haldeman.

The proposed amendment to section 5 has been informally discussed with Daniel Halperin, Assistant Deputy Secretary of the Treasury, and a member of this staff, and they have indicated that they do not oppose the specific amendment, regarding as part of the Treasury's general nonobjection to section V.

The Lehigh Valley has been a member of the Penn Central Co.'s affiliated group of corporations since 1962, and since that time has incurred substantial operating losses which have been utilized by the Penn Central affiliated group in filing its consolidated return. The losses used by the Penn Central have exceeded the Penn Central's investment in the Lehigh Valley stock, and the Penn Central has an excess loss account in the Lehigh Valley stock.

Upon approval of the Lehigh Valley plan by the reorganization court, the Lehigh Valley will no longer be a member of the Penn Central affiliated group, and the excess loss account of the Penn Central affiliated group will be restored to income unless the Penn Central group makes an election to reduce its basis in other stock or obligations of the Lehigh Valley pursuant to the consolidated return regulation.

Section 5 of H.R. 7171 provides for the restoration of a transferor railroad's net operating losses as described in section 374(e) when an excess loss account is restored to income. It does not provide for a restoration of the operating losses in the case of a basis election as described by the Lehigh Valley.

In Lehigh Valley's case, it appears relatively certain that the Penn Central will make such a basis election, and accordingly the relief afforded by section 5 will not be available to the Lehigh Valley. In order to remedy this inequitable result, we propose that section 5 of H.R. 7171 be amended to permit the restoration of the losses to a transferor railroad without regard to whether such a basis adjustment is made.

It should be emphasized that the net operating losses that are eligible are only those limited to operating losses that are carried over or available in the first taxable year of a transferor railroad ending after March 31, 1976, and such losses can only be used against valuation proceeds.

The amendment proposed by the Lehigh Valley limits the amount of a restored loss consistent with section 5.

One other significant factor is that the Penn Central has not used, so we understand, the operating losses of the Lehigh Valley in the first instance because it has had other operating losses.

Our attached memorandum describes the proposed amendment in greater detail, and explains why we believe the amendment is equitable. We would like the committee to accept our memorandum attached to our statement as it contains our proposed legislative recommendation.

Thank you.

Senator BYRD. What is the Treasury's attitude on that?

Mr. BONOVITZ. The Treasury, Senator, has agreed not to object to our proposed amendment to section 5. Although it has stated for the record that it generally opposes piecemeal tax legislation in

this area, it has viewed our amendment as being a modification of section 5 and does not object to it.

Senator BYRD. Thank you.

[The prepared statement of Mr. Bonovitz follows:]

STATEMENT OF

SHELDON M. BONOVITZ

REGARDING PROPOSED AMENDMENT TO H.R. 7171

SUBMITTED ON BEHALF OF THE

LEHIGH VALLEY RAILROAD COMPANY

My name is Sheldon Bonovitz. I am a member of Duane, Morris & Heckscher, a law firm in Philadelphia. Appearing with me today is Robert Haldeman, Trustee of the Property of the Lehigh Valley Railroad Company. The purpose of my remarks is to propose an amendment to H.R. 7171.

The Lehigh Valley Railroad Company ("Lehigh Valley") has been a member of the Penn Central Company's ("Penn Central") affiliated group of corporations since 1962. Lehigh Valley has incurred significant losses in its rail operations, and those losses have been used to offset the taxable income of other members of Penn Central's affiliated group on their consolidated tax returns. Because the losses so used have exceeded Penn Central's tax basis in its Lehigh Valley stock, Penn Central now has a substantial excess loss account with respect to that stock.

Lehigh Valley has a Plan of Reorganization presently pending before its Reorganization Court. It is anticipated that the Reorganization Court will render its decision concerning the Plan of Reorganization late this year or early next year. If the Trustee's Plan of Reorganization is consummated as it is presently drafted, Lehigh Valley will cease to be a member of Penn Central's affiliated group because the stock ownership requirements of section 1504(a) of the Internal Revenue Code will no longer be satisfied. At that time, Penn Central's excess

loss account with respect to its Lehigh Valley stock will be included in income under the consolidated return regulations, unless Penn Central elects to make a basis adjustment with respect to its Lehigh Valley stock pursuant to those regulations.

Section 5 of H.R. 7171 generally provides for the restoration of a transferor railroad's (i.e., a railroad which conveyed rail properties to Conrail and others pursuant to the Final System Plan) net operating losses subject to revival under section 374(e) of the Internal Revenue Code to the transferor railroad when the excess loss account of its parent is restored to the income of an affiliated group that filed consolidated returns with the transferor railroad. It does not, however, provide for the restoration of the transferor railroad's net operating losses when the parent elects to adjust the basis of any other stock or obligations of the transferor railroad under the consolidated return regulations. In Lehigh Valley's case, it appears reasonably certain that such an election will be made by its parent, Penn Central. Accordingly, the relief provided to other similarly situated transferor railroads under Section 5 of H.R. 7171 will be unavailable to Lehigh Valley.

In order to remedy this inequitable result, we propose that Section 5 of H.R. 7171 be amended to permit the restoration of losses to a transferor railroad without regard to whether such a basis adjustment is elected under the consolidated return regulations.

It should be emphasized that the net operating losses which are eligible for restoration to a transferor railroad under Section 5 are limited to losses carried over to or arising in the first taxable year ending after March 31, 1976, and that the net operating losses which are restored generally may only be applied against the income of the transferor railroad from the Valuation Case Proceedings in the Special Court involving the value of rail properties transferred to Conrail and others pursuant to the Final System Plan. Moreover, losses eligible for restoration to a transferor railroad which are attributable to capital gain income recognized by other members of the affiliated group (through the restoration of excess loss accounts) will be restored only in amounts equal to the ordinary income equivalent of the capital gain recognized.

The amendment proposed by Lehigh Valley would limit the amount of a restored loss in the case of a basis election to the ordinary income equivalent of the capital gain adjustment resulting from the basis election. Also because a railroad would only use a net operating loss carryover against income from the valuation case and the valuation case proceeds will be distributed in payment of the obligations in which a basis election has been made, the use of the losses by the railroad should arise at a time when there is a capital adjustment to the former parent. This is in keeping with the underlying philosophy of Section 5 which matches restoration of losses with restoration of income.

Another significant factor in this case is that Penn Central claims its excess loss account with respect to its Lehigh Valley stock is attributable to the use of losses incurred by Lehigh Valley which Penn Central apparently did not need to use on its consolidated tax return to offset the taxable income of the affiliates because Penn Central claims to have had sufficient other losses which subsequently expired to offset that taxable income without regard to the Lehigh Valley losses. The rationale for the relief provided by Section 5 of H.R. 7171 is that restoration of an excess loss account to the income of an affiliated group results in the loss of a previously claimed tax benefit. Based upon this premise, the case for providing similar relief to Lehigh Valley is even more compelling, since it appears that Penn Central never obtained a net tax benefit from the use of Lehigh Valley's net operating losses because Penn Central claims that it had expiring net operating losses of its own sufficient to offset the taxable income of its profitable affiliates.

The attached memorandum describes the proposed amendment in greater detail, and explains why be believe the amendment is equitable, would not have any significant revenue effect, and consequently should be adopted.

Thank you for the opportunity to testify here today. I would be happy to respond to any questions the Committee may have concerning the proposed amendment.

DUANE, MORRIS & HECKSCHER
16th Floor
100 South Broad Street
Philadelphia, PA 19110
215 854-6000

MEMORANDUM

July 25, 1980

Re: Proposal To Amend Section 374 Of The Internal Revenue Code To Provide For Restoration Of The Net Operating Losses Of Certain Railroad Corporations

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I. Background

The Lehigh Valley Railroad Co. ("LVR") has been a member of The Penn Central Company's ("PCC's") affiliated group of corporations since 1962. The losses incurred by LVR in its rail operations have been used to offset the taxable income of other members of PCC's affiliated group on their consolidated tax returns. In most cases, this taxable income was earned by PCC affiliates which were not involved in the railroad operations. It is understood that these absorbed losses have resulted in PCC having an excess loss account of approximately $35,000,000 with respect to its stock of LVR. It is further understood that PCC claims that it had sufficient losses which subsequently expired to offset the taxable income of its profitable affiliates, so that the LVR's losses would not have been needed by PCC to offset such taxable income.

LVR has been a debtor in reorganization under section 77 of the Bankruptcy Act since July 24, 1970. On March 13, 1973, LVR petitioned the Reorganization Court for authority to cease operations and dispose of its properties. This petition was not acted upon. Rather, under the Regional Rail Reorganization Act of 1973, as amended ("Rail Act"), LVR was required in the public interest to continue its rail operations until an orderly conveyance of its rail properties to Conrail could be consummated. On April 1, 1976, LVR conveyed most of its rail properties to Conrail and others pursuant to the Final System Plan and ceased its rail operations. Until the conveyance, however, LVR was compelled to continue incurring losses in its rail operations, part of which were used each year by the PCC affiliated group to offset the taxable income of profitable affiliates not engaged in railroad operations.

On December 29, 1977, LVR submitted a Plan of Reorganization to the Reorganization Court. Hearings have been held on the Plan, but the Court has not yet rendered a decision on the Plan. If the Plan is approved as it is presently drafted, then LVR will no longer be a member of the PCC affiliated group, because PCC will no longer satisfy the stock ownership requirements contained in section 1504(a). Until the Plan is approved, however, LVR will remain a member of the PCC

affiliated group. Accordingly, the losses it has incurred since the conveyance date in its efforts to reorganize will continue to be used by the PCC affiliated group to offset taxable income from nonrailroad sources, thereby increasing PCC's excess loss account in its LVR stock.

Along with other bankrupt Northeast railroads, LVR is presently pursuing litigation before a Special Court established by the Rail Act to determine the value of its assets transferred to Conrail. These proceedings are expected to take at least several years to complete. Upon completion of this litigation, the transferor railroads, including LVR, will be paid in Conrail securities and certificates of value of the United States Railway Association.

II. Section 374(e) and H.R. 7171

Section 374(e) was added to the Code in 1976 and was designed by Congress to preserve the loss carryovers of transferor railroads, including LVR, beyond the time that they would ordinarily expire, so that these loss carryovers may be used to offset any taxable income realized by the transferor railroads as a result of a recovery in the valuation litigation.

In certain instances, however, the net operating losses of the transferor railroads may not be available, because they have already been used by the other profit members of an affiliated group on a consolidated tax return. Such use of the railroads' losses by other profit members of an affiliated group has given rise to excess loss accounts (as defined in Reg. §1.1502-32(e)) in the transferor railroads' stock, which excess loss accounts will be triggered and restored to income upon the transferor railroads' leaving their affiliated groups. Hence, although the excess loss accounts will be restored to income, the net operating loss carryovers which generated such excess loss accounts will not be restored to the transferor railroads.

To remedy this situation, in section 5 of H.R. 7171, it is provided that if an excess loss account arising from the net operating losses of a transferor railroad is restored to income of the affiliated group which filed consolidated returns with the transferor railroad, those losses which are subject to revival under section 374(e) will be restored to the transferor railroad in an amount which corresponds to the income recognized by the affiliated group through triggering the excess loss account. Moreover, because section 374(e)

applies only to those net operating losses incurred before or during the taxable year which includes April 1, 1976 (the date of the transfer to Conrail), the net operating losses which are eligible for restoration to the transferor railroads under section 5 of H.R. 7171 are limited to those of the transferor railroad which were incurred either in the first taxable year which ends after March 31, 1976, or in a prior taxable year and which could be carried over to the first taxable year which ends after March 31, 1976.

III. Proposed Amendment To Section 374 And H.R. 7171

In LVR's case, PCC's excess loss account with respect to its LVR stock will be triggered no later than the date on which LVR's Plan of Reorganization is consummated, and LVR thereby ceases to be a member of the PCC affiliated group. Although PCC will generally be required to restore its excess loss account to income on such date, under Reg. §1.1502-19(a)(6) PCC may elect to reduce its basis in its other stock or obligations of LVR by an amount equal to the excess loss account, and thereby defer the restoration of the excess loss account into income until it disposes of its other stock or other obligations of LVR.

If the present Plan of Reorganization of LVR is approved, PCC will own other stock and securities of the Reorganized LVR, the basis of which may be sufficient to completely absorb the excess loss account with respect to its present LVR stock. Although the election, if made, will delay the time when PCC must take the excess loss account into income, it will not reduce or eliminate such income.

It is respectfully submitted that transferor railroads, including LVR, should not be penalized and denied the use of net operating losses which are otherwise eligible for restoration under H.R. 7171, merely because their parents, including PCC, make the election to adjust the basis of other stock and securities in accordance with Reg. §1.1502-19(a)(6). This constitutes an event over which the transferor railroads, including LVR, have no control. Moreover, the Treasury will not be significantly affected, inasmuch as the deferred income will eventually be recognized when the other stock or securities are sold. This conclusion is even more compelling in LVR's case, inasmuch as it appears that PCC obtained no net tax benefit from using LVR's net operating losses because PCC appears to have had expiring net operating losses of its own sufficient to offset the taxable income of its profitable affiliates.

Generally, this deferred income will be capital gain to the parent where the election is filed under Reg. §1.1502-19(a)(6). Under H.R. 7171, where losses eligible for restoration to the transferor railroad are attributable to capital gain income recognized by the affiliated group, the net operating losses will be restored to the transferor railroad only in amounts equal to the ordinary income equivalent of the capital gain. Accordingly, the proposed amendment to section 374 and H.R. 7171 restores net operating losses to a transferor railroad subject to the capital gains limitation, but regardless of whether the transferor railroad's parent recognizes the excess loss account as income or elects to reduce the basis of other stock or obligations of the railroad in accordance with Reg. §1.1502-19(a)(6).

The specific language to accomplish this result is set forth below as an amendment to section 5 of H.R. 7171:

SEC. 5. RESTORATION OF CERTAIN NET OPERATING LOSS CARRYOVERS TO RAILROADS IN CONRAIL PROCEEDINGS WHERE OTHER MEMBERS OF CONSOLIDATED GROUP HAD INCOME BECAUSE OF STOCK DISPOSITION.

(a) IN GENERAL.--For purposes of subsection (e) of section 374 of the Internal Revenue Code of 1954 (relating to use of expired net operating loss carryovers to offset income arising from certain railroad reorganization proceedings), if--

(1) subparagraphs (A) and (B) of paragraph (1) of such subsection are satisfied with respect to a corporation,

(2) such corporation had a net operating loss for a taxable year which would have satisfied the requirements of clause (i) of subparagraph (C) of such paragraph (1) but for the fact that such net operating loss was used to reduce the income of an affiliated group of corporations which filed a consolidated return, and

(3) any portion of the amount so used was included in an excess loss account which was required to be restored to the income of a member or members of the affiliated group, (determined without regard to whether the election under Reg. § 1.1502-19(a)(6) is filed),

then an amount equal to the restoration amount shall be treated as meeting the requirements of subparagraph (C) of such paragraph (1).

(b) RESTORATION AMOUNT DEFINED.--

(1) IN GENERAL.--For purposes of subsection (a), the term 'restoration amount' means, with respect to the net operating loss for any taxable year, an amount equal to the sum of--

(A) so much of the portion referred to in subsection (a)(3) as was required to be treated as ordinary income, and

(B) an amount equal to so much of such portion as was required to be treated as long-term, capital gain, multiplied by the capital gain conversion fraction.

(2) CAPITAL GAIN CONVERSION FRACTION.- For purposes of paragraph (1), the capital gain conversion fraction is a fraction--

(A) the numerator of which is the rate of tax set forth in section 1201(a)(2) of such Code for the taxable year the portion was required to be included in income, and

(B) the denominator of which is the highest rate of tax set forth in section 11(b) of such Code for such taxable year.

(3) FIFO RULE FOR ADDITIONS TO EXCESS LOSS ACCOUNT.--For purposes of this subsection, the amount in any excess loss account at the time of restoration (and the ordinary income portion of the restoration) shall be treated as attributable to net operating losses in the order of the years in which the respective net operating losses arose.

(4) For purposes of subsection (a), if the election under Reg. § 1.1502-19(a)(6) is filed, the 'restoration amount' shall be deemed to be treated as capital gain.

(c) EFFECTIVE DATE.--This section shall apply to restorations occurring after March 31, 1976.

Senator BYRD. Mr. Challoner.

STATEMENT OF DAVID CHALLONER, DEAN, ST. LOUIS UNIVERSITY SCHOOL OF MEDICINE

Mr. CHALLONER. My name is David Challoner. I am the dean of the medical school of the St. Louis University School of Medicine.

I am here this morning representing the Association of American Medical Colleges, the Association of American Universities, the National Association of State Universities and Land Grant Colleges, the National Association of Independent Colleges and Universities, and the American Council on Education.

I am accompanied by Mr. Joseph Keyes from the Association of American Medical Colleges.

I am speaking to S. 2938 to amend section 117 of the Internal Revenue Code of 1954 to provide that Federal grants for tuition and related expenses at institutions of higher education shall not be includible in gross income merely because the recipient is required to render future services as a Federal employee, and for other purposes.

H.R. 7171 contains provisions similar to S. 2938, but does not include the provisions of section 2 of S. 2938, and I would like to address the need for this section.

The associations of institutions of higher education which I represent, and I personally very much appreciate this opportunity to present this statement on S. 2938.

My personal and professional interest in the tax status of various Federal scholarship programs stems in part from my responsibilities as dean of a medical school, and in part from my service as chairman of the Panel on Clinical Sciences of the National Academy of Sciences National Research Council Committee on a study of the national need for biomedical and behavioral research person-

nel, a group constituted to fulfill the mandate of the 1974 National Research Service Awards Act.

In addition, I have served as president of the American Federation for Clinical Research.

The associations are gratified that section 2 of S. 2938 addresses the tax status of National Research Service awards. They are disappointed that the exemption would again be time limited, and that the Congress will be passing up this opportunity for a permanent solution of the issue. However, they are hopeful that in the time provided by the 1-year extension of the exemption that IRS will reverse its ruling on the taxability of the National Research Service awards.

There is a continuing need to attract the most creative aspirant scientists into the national research effort. This has become increasingly apparent over the past several years, and this need is particularly acute in the area of the clinical sciences.

Data now available demonstrates that alarming few physicians are being attracted to research careers. Continued uncertainty as to the taxability of NRSA awards inhibits effective career planning of those contemplating participation in the program. The lapse of the current exemption would act as a true disincentive to enter research.

Since 1937 the National Institutes of Health, and the National Institute of Mental Health have supported a variety of predoctoral and postdoctoral research training programs. Awards under these programs have never been regarded as resulting in the provision of taxable income to the recipients until December 15, 1976, when the Director of the Audit Division of the IRS informed the Public Health Service that the conditions imposed upon the recipient under the National Research Service Act of 1974 constitute a substantial quid pro quo in return, and thus remove them from the coverage of section 117.

The IRS cited the Supreme Court decision of *Bingler* v. *Johnson* in 1969 setting forth the substantial quid pro quo test. That test was viewed as applicable here, primarily because the recipient must, within 2 years after completion of the award period, engage in health research or teaching, or some equivalent service for a period equal to the award.

In the opinion of the associations, the promise of NRSA recipients to engage in research, or similar service, is not the kind of quid pro quo within the contemplation or consideration of the *Bingler* case. The recipient does not agree to accept employment with any entity, but merely to continue in research or engage in alternative service for whatever employer he can find, if any, for a specified period of time.

This same position has been taken by the House Interstate and Foreign Commerce Committee in a report which we will submit for the record. To date, the IRS has not followed the opinion of the House committee. Finally, that committee endorsed legislation to restore the tax exclusion in the event the IRS refused to honor the committee's intent.

Subsequent legislation, section 161 of the Revenue Act of 1978, has restored the exclusion on a temporary basis. S. 2938 would extend the exemption for an additional 1-year period. We would

greatly appreciate a permanent resolution of this matter consistent with 40 years of previous policy which would obviate the continued uncertainty and the need for repeated congressional action on a matter in which the purposes to be served all forcefully argue that the award constitutes a scholarship under applicable provisions of the law.

Thank you.

Senator BYRD. What is the attitude of the Treasury?

Mr. CHALLONER. We don't know, Senator.

Mr. KEYES. Let me amend that slightly. Mr. Halperin did not this morning to my knowledge address this issue, but I have been informed of conversations that Mr. Halperin has had with officials at the National Institutes of Health in which he has indicated that he is persuaded by the argument we have made, and is interested in having the Internal Revenue Service review its revenue ruling, and perhaps to reverse it during the coming year.

Senator BYRD. What types of Federal scholarship programs are covered under section 1 of the bill?

Mr. CHALLONER. Under section 1, Senator, the Armed Forces scholarship program, where students receive a stipend and tuition for subsequent service after medical school, and the National Health Service Corps scholarship program.

Senator BYRD. With regard to the scholarship income, has not Congress deferred taxation on several occasions.

Mr. CHALLONER. In the past, yes, sir. The current legislation, however, makes the stipend portion of both of these service scholarship programs taxable. This is a provision that I would prefer not to see.

Senator BYRD. You mean the provision of H.R. 7171.

Mr. CHALLONER. Correct. The section that makes the stipend portion taxable.

[The prepared statement of Dr. Challoner follows:]

Statement of the

ASSOCIATION OF AMERICAN MEDICAL COLLEGES

and

ASSOCIATION OF AMERICAN UNIVERSITIES

and

NATIONAL ASSOCIATION OF STATE UNIVERSITIES
AND LAND GRANT COLLEGES

and

NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES
AND UNIVERSITIES

and

AMERICAN COUNCIL ON EDUCATION

on

S.2938
(To amend Section 117 of the Internal Revenue Code of 1954)

The associations of institutions of higher education whom I represent, and I personally, very much appreciate this opportunity to present this statement on S.2938. My personal and professional interest in the tax status of various Federal scholarship programs stems in part from my responsibilities as dean of a medical school and in part from my service as Chairman of the Panel on Clinical Sciences of the National Academy of Sciences' National Research Council Committee on a Study of National Needs for Biomedical and Behavioral Research Personnel, a group constituted to fulfill the mandate of the 1974 National

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Presented by David R. Challoner, M.D., Dean, Saint Louis University School of Medicine to the Senate Finance Committee, Subcommittee on Taxation, August 4, 1980.

Research Service Awards Act.

The associations are gratified that your committee is taking steps to develop a permanent resolution of the tax status of the Armed Forces and National Health Service Corps Scholarship programs; this action will provide students contemplating participation in these programs and institutions administering them the requisite certainty regarding the tax consequences of such participation for intelligent decision making about career choices. They are disappointed in the limited nature of the exemptions proposed by S.2938: their applicability only to tuition and fees in the case of those programs requiring the recipient to render future service as a Federal employee, and the single year extension of the treatment of National Research Service Awards as scholarships under Section 117 of the Internal Revenue Code of 1954.

The National Health Service Corps (NHSC) and Armed Forces Health Professions Scholarship programs are intended to address important national problems--the NHSC is aimed at meeting the need for health services in health manpower shortage areas and the Armed Forces program at insuring an adequate supply of physicians to meet the medical care needs of members of the military forces. The continuing concern of Congress about these health manpower problems is indicated by recent activities of several of its authorizing committees. The associations respectfully urge this Committee to not take any action that would, even to a minor degree, serve as a disincentive to enter either the NHSC program or the Armed Forces program, both of which are

so clearly in the national interest. Such a step would seem to contradict the current Federal policy in these areas.

On first blush, the actual effect of the exclusion of the stipend for living expenses from the proposed tax exemption would seem minor. An unmarried scholarship recipient with no other income would be taxed approximately $310.00 This amount is, however, over 6% of living expenses received under these programs and thus is not an insignificant amount to the individual trying to make ends meet during these inflationary times. On the other hand, viewed from the perspective of the U.S. Treasury, the total amount of taxes to be received in its coffers under this proposal is miniscule indeed.

The associations are gratified that S.2938 addresses the tax status of National Research Service Awards. They are disappointed that the exemption would again be time limited and that the Congress will be passing up this opportunity for a permanent resolution of the issue. However, they are hopeful that in the time provided by the one year extension of the exemption that IRS will reverse its ruling on the taxability of the National Research Service Awards. There is a continuing need to attract the most creative aspirant scientists into the national research effort. As has become increasingly apparent over the past several years, this need is particularly acute in the area of the clinical sciences. Data now available demonstrates that alarmingly few physicians are being attracted to research careers. Continued uncertainty as to the taxability of NRSA awards inhibits effective career planning of those contemplating participation in the program. The lapse of the current exemption would act as a true disincentive to enter research.

Since 1937, the National Institutes of Health (NIH) and the National Institute of Mental Health (NIMH) have supported a variety of predoctoral and postdoctoral research training programs. Awards under these programs had never been regarded resulting in the provision of taxable income to the recipients until December 15, 1976 when the Director of the Audit Division of the Internal Revenue Service informed the Public Service that the conditions imposed on the recipient under the National Research Service Act of 1974 constitute a substantial quid pro quo in return and thus remove them from the coverage of Section 117. The first published expression of the IRS view appeared in Rev. Rul. 77-319 the following year. Citing the Supreme Court decision in Bingler v. Johnson, 394 U.S. 741 (1969) setting forth the substantial quid pro quo test, the Rev. Rul. concluded that the test was met by the award requirements that : "(1) the recipients must, within two years after completion of the award period, engage in health research or teaching or some equivalent service for a period equal to the award, and (2) the government reserves the right to make royalty-free use of any copyrighted materials produced as a result of the research performed during the award period."

The facts in Bingler, upon which the Supreme Court relied in finding a substantial quid pro quo were considerably more compelling than are the facts with regard to NRSA awards. Three of the factors upon which the Court relied are not at all present

in the case of NRSA awards: the grantor, Johnson Company, was a for-profit corporation and the recipient had a pre-existing employment relationship with Johnson; there was a close relationship between the recipient's grant from Johnson and his prior salary; and the recipient's research related to the grantor's business. Finally, perhaps the most important factor in Bingler was that the recipient of the fellowship was required to return to work for Johnson upon completion of the fellowship. The IRS in its ruling on NRSA awards argued that while no employment relationship exists between the grantor, the Federal government, and the grantees, the services required are designed to accomplish a basic objective of the grantor and thus the NRSA awards fall within the exclusion from Section 117 mandated by the Bingler decision. In the opinion of the associations, the promise of NRSA recipients to engage in research or similar service is not the kind of quid pro quo within the contemplation or consideration of the Bingler case. The recipient does not agree to take employment with any entity but merely to continue in research (or engage in alternative service) for whatever employer he can find (if any) for a specified period of time.

This in fact is the position taken by the House Interstate and Foreign Commerce Committee which considered this matter in its report on the Biomedical Research and Research Training Amendments of 1978. "The committee. . .considers the Internal Revenue Service's ruling on National Research Service Awards a misreading of the purpose of these awards. The primary purpose of such awards is not, in fact, payment for service, but is to provide

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training for individuals in order that they may be better equipped to pursue a career in research." (Report No. 95-1192, page 36.) The committee then expresses the hope that the IRS would reverse its ruling in light of the statement of the committee intent. To date, the Service has not done so. Finally, the committee endorsed legislation to restore the tax exclusion in the event that the IRS refused to honor the committee's intent.

Subsequent legislation--Section 161 of the Revenue Act of 1978--has restored the exclusion on a temporary basis. S.2938 would extend the exemption for an additional one year period. The higher education community would greatly appreciate a permanent resolution of this matter which would obviate the continued uncertainty and the need for repeated congressional action on a matter in which the purposes to be served, the history and traditions of the program and the Congressional intent all forcefully argue that the awards constitute a scholarship under applicable provisions of law.

Senator BYRD. Thank you, gentlemen.

The final panel of four, each witness limited to 5 minutes, will discuss S. 2805. S. 2805 is opposed by the Treasury Department. The witnesses will be Mr. Leo Albert, Association of American Publishers, Inc.; Mr. Jack O. Snyder, executive vice president of Harcourt Brace & Jovanovich; Charles Carter, senior vice president of Stewart-Warner Corp.; and Thomas F. Roche, legal counsel, National Association of Wholesaler-Distributors.

Welcome, gentlemen.

STATEMENT OF LEO ALBERT, ASSOCIATION OF AMERICAN PUBLISHERS, INC.

Mr. ALBERT. Thank you, Mr. Chairman.

I am Leo Albert, chairman of the Association of American Publishers. With the chairman's permission, and in the interest of time, I will dispense with the reading of my testimony, and I will ask that it be made part of the official record.

Senator BYRD. It will be.

Mr. ALBERT. I will limit my comments to stressing one major aspect of the *Thor* impact on publishing. It has to do with publishers of elementary and high school books.

In the process of obtaining adoptions in the various States, in fact in all of the States, and also some of the major cities like New York and Chicago, publishers are required to sign a contract which stipulates in part that the publisher guarantees to have books

available during the duration of the adoption. Most adoptions are for a period of 3 years, and renewable for a 1- or 2-year period.

In fact, the State of Louisiana has an open-ended adoption system, which means that the publisher must guarantee to have books in stock without any guarantee whatsoever that those States will buy 1, 500, or 1,000 copies.

The impact on the publishers will be very severe because in cases where an adoption may consist of a K through 8 series, to go back to press for 500 copies or 1,000 would be economically impractical. So in the long term the impact of the *Thor* decision on IRS, I believe, will be a loss of revenue.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Albert follows:]

TESTIMONY OF LEO ALBERT, CHAIRMAN OF THE BOARD OF DIRECTORS OF THE ASSOCIATION OF AMERICAN PUBLISHERS, INC.

Mr. Chairman, Members of the Committee.

I am Leo Albert, Chairman of the Association of American Publishers, Inc. The Association is the principal trade representative of book publishers in the United States, with a membership of more than 350 publishing houses which includes trade book publishers, school and college text book publishers, university presses and publishers of technical and scientific texts and journals, as well as others in the information fields. We welcome this opportunity to comment on S.2805 which is designed to limit the effects of the Supreme Court's decision in Thor Power.

We strongly endorse S.2805 because it will limit the devastating effects upon the dissemination of information which the IRS implementation of Thor Power threatens.

S.2805 represents a measured, but nonetheless important, first step in resolving the chaos wrought by the Supreme Court in its Thor Power decision and the IRS revenue rulings issued pursuant to that decision, which apply its holding retroactively to the first taxable year ending after December 25, 1979. Superficially, Thor Power and the the retroactive application of that case by the IRS may seem to involve merely

technical accounting matters. The effects of these actions may therefore seem obsure. But, the consequences--in terms of the impact on publishers, authors and the public as related to the free flow of information in this country--are real and far reaching.

The question in Thor Power involves the treatment of inventory for tax purposes. In accordance with generally accepted accounting principles, it has been the practice for industries which carry significant inventories and which value inventory on the lower of cost or market for tax purposes, to write-down on a periodic basis to eliminate excess inventory. Indeed, such practice is a virtual necessity in order to avoid misleading creditors or investors as to the true value of current inventory. The practice has been widespread in the publishing industry, especially among publishers of scholarly, scientific and technical works. These books are typically not best-sellers and therefore, stock of books in print tend to be slow moving. Prior to Thor Power, the practice of writing down inventory was treated as a charge against closing inventory, resulted in an increase of cost of goods sold, and a resultant decrease in gross profits reported for tax purposes. Although book publishers thus wrote down their inventory, the books were retained against the possibility of future sales. If sold,

the profits from these slow moving books were of course, duly reported as a part of gross profits at the time of sale.

Thor Power changes all of this. As one book publisher explained, the effect of the decision and the IRS's follow-up regulations is that

> "It is not permissible, for tax purposes, to reduce the value of an overstock title unless you take one of two actions: (1) sell the books at less than cost; (2) scrap the books physically."

The first of these options is sometimes referred to in the publishing trade as remaindering. But, this is an option which is by no means routinely available to publishers: Some books--notably scholarly, technical or scientific works -- simply do not appeal to readers who patronize remainder shops; and there is thus no market for remaindering. Moreover, the possibilities of remaindering are very limited in the case of small and medium size publishers. In the case of small publishers, inventory may be large in terms of the publishers overall operation, but it is simply too small for remainder book stores to want to be troubled with. In all too many cases, the effect of the IRS rulings and Thor Power is to require publishers to scrap the books--to destroy, to shred or burn them.

The social consequences of this ruling are clear and clearly undesirable. The ruling will force publishers, especially small publishers to destroy inventories of slow selling books. This will reduce the nation's knowledge resources; it will restrict profits to publishers upon which new books must depend; and it will limit royalties payable to authors for their creative efforts. It will, in a word, leave creators, the publishing industry and the country economically and culturally poorer.

But, the Internal Revenue Service has taken this already serious situation and made it even worse. As we have noted, the effect of the IRS rulings is to apply the Thor Power policy retroactively to all taxable years ending after December 25, 1979. This retroactive ruling makes the burden of the IRS policy change almost intolerable for medium sized, and unbearable for small sized publishers. It is therefore quite properly a subject which should be of great concern to this Committee.

For more than a year after the Thor Power decision, the IRS did nothing about follow-up regulations. In the face of this silence, publishers, as well as other businessmen, were forced to make decisions as to the treatment of their inventory. Acting on the advice of competent, skilled

certified public accountants, consultants and tax counsel many elected to continue to treat their inventory as they had prior to Thor Power. The advice which publishers received was given in good faith. Some tax experts concluded, with considerable justification, that the publishers' inventory practices could not be changed without prior approval of the Commissioner: IRS regulations require that Commission approval be obtained before a company adopts changes in accounting practices affecting tax computations. Other tax experts concluded, with equal justification, that no action could be taken until the IRS formulated its policy on inventory write-downs because of uncertainty as to the scope of the change worked by Thor Power. There was a strong, -- and we believe well grounded feeling -- that the Thor Power ruling would be held inapplicable to book publishing because of its extraordinarily adverse impact on the dissemination of information to the American public.

When no IRS rulings were forthcoming by the end of calendar year 1979, book publishers and their consultants and advisors felt secure that any Thor adjustments to inventory would be required to the 1980 or later taxable years. These expectations were confounded: in February 1980--nearly 13 months after the Supreme Court's decision--the IRS issued rulings 80-5 and 80-60 which make the Thor Power policy

applicable to book publishers and applies it retroactively to taxable years ending after December 25, 1979.

The consequences of this retroactive ruling to the publishing industry and, as a result to the American public, will be catastrophic. It will have the effect of severly distorting 1979 income of book publishers. Had the ruling been issued to operate prospectively, previous impermissible write-downs could still have been restored; and, after analysis of the existing inventory, the publishers could have scrapped or made the requisite offering thus beginning its post-Thor inventory in compliance with IRS procedures. But that option is not open under the IRS ruling. As one knowledgeable publisher put it, the retroactive effect of the revenue rulings means that

> "The tax bite will be crippling: for some medium sized publishers it exceeds a Million Dollars--unless they march into their warehouses with a flame-thrower."

And the impact upon a small publisher, although smaller in dollar terms, will be even more severe. Nor is this impact significantly ameliorated by the provisions of the ruling which permit the retroactive tax adjustments to be paid over a ten year period. The books will be destroyed, instead!

This is an unseemly prospect for a country, such as ours, which cherishes freedom of expression and the free flow of information and which has embodied these precepts

in the First Amendment to the Constitution. Nor is this spectacle even desirable from the IRS standpoint. The IRS may well find its collections running lower, not higher because of the retroactive application: a book which has been destroyed can never yield a tax payment; by contrast, permitting taxpayers the opportunity adjust and to sell excess inventory is more likely to make some contribution to gross profits and therefore to taxes payable.

We support S.2805 precisely because it is a first step to eliminate the problems created by Thor Power. As Senator Nelson succintly explained when he introduced the bill, it "simply would prevent the retroactive application" of the revenue rulings and thereby would allow taxpayers to conform to the rulings' prescribed method by either scrapping items of inventory which were held during 1979 or by offering the items for sale at a lower price.

We believe that this legislation is urgently needed. We hope that we have persuaded you this morning as to its importance. We therefore urge favorable and expeditious passage of S.2805.

STATEMENT OF JACK O. SNYDER, EXECUTIVE VICE PRESIDENT, ACCOMPANIED BY WILLIAM BRANDNER, SENIOR VICE PRESIDENT AND TREASURER, HARCOURT BRACE JOVANOVICH, INC.

Mr. SNYDER. I am Jack Snyder, executive vice president and member of the office of the president of Harcourt Brace Jovanovich, Inc. With me is William Brandner, senior vice president and treasurer of Harcourt Brace Jovanovich, Inc. We appear before you to urge your support for Senate bill S. 2805, introduced by Senator Nelson to provide that Revenue ruling 80-60 shall not require a change in the taxpayer's method of accounting for taxable years beginning before 1980.

Harcourt Brace Jovanovich, Inc., a New York Stock Exchange company, is engaged primarily in book publishing, professional instruction, and magazine publishing for industry, farming and education, insurance and instructive entertainment. Our principal office is located at 757 Third Avenue, New York, N.Y., and we have locations throughout the United States, Canada, and in Europe.

Each year we publish approximately 500 textbooks and related materials for elementary and secondary schools, 200 undergraduate college textbooks in humanities, science, social sciences, and business disciplines, 700 graduate and postgraduate scholarly works in science and medicine, and 80 trade books of fiction and nonfiction.

Our initial printing of a book, and the subsequent reprinting of that book are based on sales projections and can be as few as 1,000 copies for a high-priced scholarly work for a limited audience, to several hundred thousand copies in the case of an elementary textbook series to be sold to a large school population.

Obviously, we have no incentive to print more copies of the books than we think we can sell. Telling a customer we are out of stock means losing an order. Each book is unique, but nonetheless publishing is competitive and you can lose business being out of stock.

We tend in some instances to over print because we are in part hopeful, and because book buying involves millions of individual decisions, and we cannot estimate precisely the course of those decisions.

Where we have over printed and wind up with excess inventories, we have attempted in the past to dispose of those inventories for the greater good of society, at the greatest economic benefit of Harcourt Brace Jovanovich, Inc. The two principal sources of disposal have been remainder sales of books and charitable contributions of books.

For a variety of reasons, including contracts with authors, State education departments, and also Robinson-Patman Act provisions, we are precluded from disposing of such excess inventory to these sources for periods of time which could be as much as 5 years.

Revenue ruling 80-60 will cause us to evaluate the present value of a current tax deduction by immediate destruction of excess inventories of books as opposed to waiting out contract provisions or other requirements which would permit remainder sales or donations.

Like many other book publishers, Harcourt Brace Jovanovich, Inc., has consistently followed the practice of writing down its excess inventory estimated net realizable value. I draw your attention to two gross inequities that will result unless the bill is passed.

First, Revenue ruling 80-60 and Revenue procedure 80-5 were both issued at the end of January 1980. This does not give our business and similar businesses time to revise in an orderly fashion our inventory procedures for fiscal 1979.

Second, the Revenue ruling and Revenue procedure make the accounting for inventory retroactive for inventories on hand at the end of 1979 and 1978.

We believe that we have consistently followed proper accounting, and the write-downs of our excess inventory have been proper, and have been sustained in audits made by the Internal Revenue Service over a long period of time. Further, these write-downs are required under generally accepted accounting principles, and we must continue to record them for financial statement purposes.

Revenue ruling 80-60 and Revenue procedure 80-5 were issued late in January 1980, and made retroactive for fiscal years ending after December 25, 1979. This requires adjustments to beginning and ending inventories for the calendar year 1979, or write-downs

of inventories that have not been scrapped or otherwise destroyed, sold or offered for sale at the written down price by January 30, 1980.

The timing of the release of this Revenue ruling did not provide sufficient time for taxpayers to reduce their 1978 excess inventories in accordance with its requirements, and it is therefore grossly unfair.

It seems to us plainly punitive to enforce a change in the rules retroactively when in fact there is no accusation or explanation that companies have sought to evade or avoid taxation by following generally accepted accounting rules in the past.

In short, unless the present bill is passed, we publishers like other businesses are in the position of someone who is invited to dinner and told for the first time as he approaches the front door that the dinner is black tie, and what's more, that his wardrobe over the past decade has plainly been inadequate.

Fair is fair. We do not object to a change in accounting procedures. We do object to being given too short a notification, and we do object to being penalized retroactively without any imputation that we have sought public favor or avoided public responsibility as businessmen.

Thank you for the opportunity to appear before you to state our views on S. 2805, and if you have any questions, we will be pleased to answer them.

Senator BYRD. Has your company filed its 1979 income tax return?

Mr. BRANDNER. No, sir. We have it on extension. We have made our estimated payments in accordance with Internal Revenue procedures. We have paid our tax.

Senator BYRD. You have not filed your report. So you would not be required to revise the report because you have not filed it.

Mr. BRANDNER. We are required to file our quarterly estimates in accordance with the new Revenue procedure, which we have done. We have not actually filed the return. It is extended until September 15.

Senator BYRD. As I understand it, this bill that you are advocating applies only to 1 year. After that you would have to adopt this new procedure.

Mr. BRANDNER. The bill as it stands prevents the Revenue ruling to be applied retroactively.

Senator BYRD. For 1 year.

Mr. BRANDNER. The cost to Harcourt Brace Jovanovich, if it is applied retroactively, is $5 million. Our objection is that we did not have sufficient notice to do anything with our inventories to meet the requirements of the new rule.

Senator BYRD. You are not speaking of the future there. You are only concerned about 1 year.

Mr. SNYDER. We are responding to this bill which eliminates that retroactive part. We are against the procedure entirely.

Senator BYRD. But this bill does not take care of anything except the 1979 return.

Mr. SNYDER. The discussion of the school books also applies to trade books as far as author's contracts. There are a lot of other reasons that we have to keep the books.

Senator BYRD. What I am getting at is that this legislation does not take care of your problem except for 1 year.

Mr. SNYDER. As far as destroying books, all that does is give us time to destroy them so we would not have to pay the back taxes.

Mr. BRANDNER. Mr. Chairman, in the interest of time, Mr. Snyder skipped one paragraph, but I think that it is germane to what you are talking about, if I may just read it.

The bill before you does not accomplish everything we publishers would wish, but we regard it as reasonable and, indeed, helpful. We may have to, under the new IRS ruling or procedure, print fewer copies of some books, thus raising our unit cost which may cause us possibly to increase prices. We can endure that, and we will do so by trying to improve our productivity.

Senator BYRD. Let me ask you this. Let's assume that this bill is not passed, you can destroy these books for the upcoming year, and take a deduction then, can you not?

Mr. BRANDNER. Yes, we can, Senator, but of course there will be an interest cost running on our taxes. We are limited by the provisions of the ruling to destroy only a certain amount or trigger the entire tax liability, and not allow us a 10-year spread of payments for excess inventories that are on hand from prior periods.

Senator BYRD. But you are not precluded from taking a tax loss by destroying the books in 1980 instead of in 1979?

Mr. BRANDNER. No, we are not.

Mr. SNYDER. It just makes no sense for the publishing business to do that, and it makes no sense for the Treasury because to the extent that we sell those titles in the future, the tax is paid on the revenue from that. Once it is destroyed, it is a permanent destruction of something real.

Senator BYRD. I don't see that it makes a great deal of difference to you when you can destroy the books and take it off in 1980. It is just a question of whether you do it in 1979 or 1980; isn't that right?

Mr. BRANDNER. Our preference would be not to destroy the books. Our preference would be to put the books on the marketplace where they could be read.

Senator BYRD. Whatever you are going to do with them, you can do it in 1980 as well as 1979, can you not?

Mr. BRANDNER. We are precluded under contract from selling books at remainder prices for periods of time. Under contracts with State education departments, as the previous witness testified, we have to keep inventories on hand in certain States for the duration of the contract.

Senator BYRD. But that is an argument against the total proposition.

Mr. BRANDNER. That is correct.

Senator BYRD. What I am trying to understand in my own mind is, if this bill is not passed, you can still take your deduction for the year 1980, which you would have taken or wanted to take for the year 1979.

Mr. BRANDNER. We are able to review our inventories very closely in 1980, and destroy those quantities which we estimate we will never sell. We will, of course, then be precluded from selling them at reduced prices, we will have to destroy them.

Senator BYRD. Thank you.

[The prepared statements of Messrs. Snyder and Brandner follow:]

TESTIMONY OF JACK SNYDER,

EXECUTIVE VICE PRESIDENT AND MEMBER OF

THE OFFICE OF THE PRESIDENT

OF HARCOURT BRACE JOVANOVICH, INC.

AND

WILLIAM BRANDNER, SENIOR VICE PRESIDENT AND TREASURER

OF HARCOURT BRACE JOVANOVICH, INC.

Mr. Snyder

Mr. Chairman, thank you for the opportunity to appear before you. I am Jack Snyder, Executive Vice President and member of the Office of the President of Harcourt Brace Jovanovich, Inc. I urge you to support Senator Nelson's Bill S. 2805.

Like many other book publishers, HBJ has consistently followed the practice of writing down its excess inventory to estimated net realizable value. I draw your attention to two gross inequities that will result unless S. 2805 is passed. First, Revenue Ruling 80-60 and Revenue Procedure 80-5 were both issued at the end of January this year (1980). Please note this date! It forces upon us a surrealistic situation. If we were to institute orderly procedures and dispose of excess inventory for the fiscal year 1979, we certainly need more than one week to do so -- changes under the ruling must be accomplished within 30 days of the end of the fiscal year.

Second, the Revenue Ruling and Revenue Procedure make the accounting for inventory retroactive for inventories on hand at the end of 1979 and 1978.

It is plainly punitive to enforce a change in the rules retroactively when in fact there is no accusation or explanation that companies have sought to evade or avoid taxation by following generally accepted accounting rules in the past.

In short, unless S. 2805 is passed we publishers like other businesses are in the position of someone who is invited to dinner and told for the first time as he approaches the front door that the dinner is black tie -- and, what's more, that his wardrobe over the past decade has plainly been inadequate. Fair is fair. We do not object to a change in accounting procedures. We do object to being given too short a notification; and we object to being penalized retroactively without any imputation that we have sought public favor or avoided public responsibility as businessmen.

The cost to HBJ if S. 2805 is not enacted is a cost we cannot recoup except from raising prices. We do not believe that our customers deserve a penalty owing to the past any more than we ourselves deserve such penalty.

TESTIMONY BEFORE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE UNITED STATES SENATE COMMITTEE ON FINANCE

AUGUST 4, 1980

Mr. Brandner

Mr. Chairman, I am William Brandner, Senior Vice President and Treasurer of Harcourt Brace Jovanovich, Inc. I speak to support Senate Bill S. 2805.

Each year we publish more than 1,000 books for educational, scholarly, and general audiences. Our initial printing of a book and the subsequent reprintings of that book are based on sales projections. Obviously, we have no incentive to print more copies of a book than we think we can sell.

Telling a customer we are "out of stock" means losing an order -- each book is unique, but nonetheless, book publishing is competitive and you can lose business being out of stock.

We tend in some instances to overprint because we are, in part, hopeful; and because book buying involves millions of individual decisions and we cannot estimate precisely the course of those decisions.

The Bill before you does not accomplish everything we as publishers would wish, but we regard it as reasonable and indeed hopeful. We may be forced by the new IRS Ruling and Procedure to print fewer copies of some books, thus raising our unit cost, which may cause us to absorb extra costs. We can endure that and will do so by trying to improve our productivity.

Two economic losses are involved here: first, unless S. 2805 is passed, HBJ will lose up to $5,000,000 in retroactive taxes which it cannot directly recoup through pricing and other means; second, we cannot go to the remainder market. Allow me to explain this technical aspect. Because the Ruling and Procedure allow no grace period -- quite apart from being retroactive -- we will not be able to make available millions of books to the so-called remainder market, that is, the selling of excess stock of books at greatly reduced prices (as low as 25¢ per book). Instead, we will have to destroy several million books. I hardly need point out that a book not read is nothing at all; and it would be far better for students and others to be able to buy remaindered books at a cheap price than to go empty-handed.

We have a more complete statement which we ask the Committee to print in full in the record of these hearings immediately following our remarks.

Thank you.

TESTIMONY BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY OF THE UNITED STATES SENATE COMMITTEE ON FINANCE

Mr. Chairman, I am Jack Snyder, Executive Vice President and Member of the Office of the President of Harcourt Brace Jovanovich, Inc. With me is William Brandner, Senior Vice President and Treasurer of Harcourt Brace Jovanovich, Inc. We appear before you to urge your support for Senate Bill S. 2805 introduced by Senator Nelson, to provide that Revenue Ruling 80-60 shall not require a change in the taxpayers method of accounting for taxable years beginning before 1980.

Harcourt Brace Jovanovich, Inc., a New York Stock Exchange company, is engaged primarily in book publishing; professional instruction; magazine publishing for industry, farming and education; insurance and instructive entertainment. Our principal office is located at 757 Third Avenue, New York, New York 10017. We have locations throughout the United States, in Canada, and in Europe.

Each year we publish approximately 500 textbooks and related materials for elementary and secondary schools; 200 undergraduate college textbooks in the humanities, science, social science and business disciplines; 700 graduate and post graduate scholarly works in science and medicine; and 80 "trade books" of fiction and nonfiction.

Our initial printing of a book and the subsequent reprintings of that book are based on sales projections and can be as few as 1,000 for a high priced scholarly work for a limited audience to several hundred thousand copies in the case of an elementary textbook series to be sold to a large school population. Obviously, we have no incentive to print more copies of a book than we think we can sell.

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We tend in some instances to overprint because we are, in part, hopeful; and because book buying involves millions of individual decisions and we cannot estimate precisely the course of those decisions.

Where we have overprinted and wind up with excess inventories, we have attempted in the past to dispose of those inventories for the greater good of society at the greatest economic benefit to Harcourt Brace Jovanovich, Inc. The two principal sources of disposal have been remainder sales of books and charitable contributions of books. For a variety of reasons, including contracts with authors, state education departments and also Robinson Patman Act provisions, we are precluded from disposing of such excess inventory to these sources for periods of time which could be as much as five years. Revenue Ruling 80-60 will cause us to evaluate the present value of a current tax deduction by immediate destruction of excess inventories of books as opposed to waiting out contract provisions or other requirements which would permit remainder sales or donations.

Like many other book publishers, Harcourt Brace Jovanovich, Inc. has consistently followed the practice of writing down it excess inventory to estimated net realizable value. I draw your attention to two gross inequities that will result unless the Bill is passed. First, Revenue Ruling 80-60 and Revenue Procedure 80-5 were both issued at the end of January this year (1980). This does not give our business and similar businesses time to revise in an orderly fashion our inventory procedures for fiscal 1979. Second, the Revenue Ruling and Revenue Procedure make the accounting for inventory retroactive for inventories on hand at the end of 1979 and 1978.

We believe that we have consistently followed proper accounting and the write-downs of our excess inventory have been proper and have been sustained in audits made by the Internal Revenue Service over a long period of time. Further, these write-downs are required under generally accepted accounting principles, and we must continue to record them for financial statement purposes.

Revenue Ruling 80-60 and Revenue Procedure 80-5 were issued in late January 1980 and made retroactive for fiscal years ending after December 25, 1979. It requires adjustments to beginning and ending inventories for the calendar year 1979 for write-downs of inventories that have not been scrapped or otherwise destroyed, sold or offered for sale at the written down price by January 30, 1980. The timing of the release of this Revenue Ruling did not provide sufficient time for taxpayers to reduce their 1979 or 1978 excess inventories in accordance with its requirement, and it is, therefore, grossly unfair.

It seems to us plainly punitive to enforce a change in the rules retroactively when in fact there is no accusation or explanation that companies have sought to evade or avoid taxation by following generally accepted accounting rules in the past.

In short, unless the present Bill is passed we publishers, amongst other businesses, are in the position of someone who is invited to dinner and told for the first time as he approaches the front door that the dinner is black tie -- and, what's more, that his wardrobe over the past decade has plainly been inadequate. Fair is fair. We do not object to a change in accounting procedures. We do object to being given too short a notification; and we object to being penalized retroactively without any imputation that we have sought public favor or avoided public responsibility as businessmen.

The cost to HBJ if this Bill is not enacted is a cost we cannot recoup except from customers in the future. We do not believe that these customers deserve a penalty owing to the past any more than we ourselves deserve such penalty.

The Bill before you does not accomplish everything we as publishers would wish, but we regard it as reasonable and indeed helpful. We may have to, under the new IRS Ruling and Procedure, print fewer copies of some books, thus raising our unit cost, which may cause us possibly to increase prices. We can endure that and will do so by trying to improve our productivity.

Two economic losses are involved here: first, unless the Bill is

passed, Harcourt Brace Jovanovich, Inc. will lose up to $5,000,000 in retroactive taxes which it cannot directly recoup through pricing and other means. Second, we cannot go to the remainder market. Allow me to explain this technical aspect. Because the Ruling and Procedure allow no grace period -- quite apart from being retroactive -- we will not be able to make available millions of books to the so-called remainder market, that is, the selling of excess stock of books at a greatly reduced price. Instead, we will have to destroy several million books. I hardly need point out that a book not read is nothing at all; and it would be far better for students and others to be able to buy remaindered books at a cheap price than to go empty-handed.

Thank you for the opportunity to appear before you to state our views on S. 2805. If you have any questions, we would be pleased to answer them.

Senator BYRD. The next witness.

STATEMENT OF CHARLES CARTER, SENIOR VICE PRESIDENT AND CHIEF LEGAL OFFICER, STEWART-WARNER CORP.

Mr. CARTER. Mr. Chairman, I am Charles Carter, senior vice president and chief legal officer of Stewart-Warner. With me on my right is Jack Morrison, who is controller of Stewart-Warner.

I will highlight my remarks, and I will ask that the entire statement be made of record.

Senator BYRD. It will be.

Mr. CARTER. We are appearing today to support the basic premise of S. 2805, but we feel that it is presently lacking and we feel that amendment of subparagraph (c) is in order. We are proposing that it be amended to prevent punitive measures and inequities being imposed upon taxpayers by a retroactive application of revenue ruling 80-60 by the IRS.

Under 306 of Revenue procedure 80-5 certain taxpayers are excluded from relief provided by this bill if they have open tax years. This wipes out the benefit of the proposed bill to such taxpayers.

For the excluded taxpayers, the change in accounting can be applied retroactively to the oldest open tax year of such taxpayer. The impact of this is to negate or restrict the benefit of the 10-year spread granted to taxpayers pursuant to a change of accounting procedure since the starting date can be the oldest open tax year.

Second, it allows for assessment of retroactive interest again back to the oldest open tax year.

Since the issue of the method of accounting now deemed impermissible was not finally resolved until January 16, 1979, when the Supreme Court decided the *Thor* case, we consider any retroactive application to be punitive and inequitable.

Additionally, we are concerned about the inflationary aspect of this provision. Clearly, industry will be forced to raise prices to cover the cost of retroactive interest charges and to cover the cost impact of losing full benefit of the 10-year spread for paying such taxes.

I want to make it clear that we are not opposing the taxes as such. We are only opposing the retroactive application by the IRS. We are proposing that S. 2805 be amended in subparagraph (c) to provide similar relief to taxpayers with open years so that it will become effective with the tax years after January 16, 1979.

Senator Nelson did recognize the problem of retroactive application in introducing the bill, but I suggest that neither he nor anyone in the industry anticipated that the IRS was going to apply 80–60 retroactively to all open tax years going back.

The method of accounting for excess inventories employed by *Thor* which was deemed impermissible by the Supreme Court had been employed by many taxpayers for a number of decades. The IRS had challenged such a method, and ultimately accepted the method until the *Thor* case.

For example, we at Stewart-Warner we have had this method in the mid-1950's, and the IRS accepted our method of accounting in conference. It was not until 1976, some 20 years later, that the IRS was auditing Stewart-Warner and again challenged the method of accounting. They deemed it appropriate at that time to leave the issue open until the *Thor* case was finally resolved.

The *Thor* case which arose in the late 1960's in a challenge in the Tax Court was decided in May of 1975 in the Tax Court, was affirmed by the court of appeals in September 1977, and it was not until October of 1977 that the IRS issued Revenue Ruling 77–364 clarifying their position on the method of accounting.

They had not previously issued any Revenue rulings or procedures. Thus it was more than 20 years after the 1950 challenge of Stewart-Warner, more than 8 years after the *Thor* litigation began, and subsequent to the court of appeals affirmance before the IRS officially went on record.

Subsequent to the Supreme Court decision, we did follow IRS's statement that they had filed, and we voluntarily filed for a change in accounting. The IRS then hit us by pushing it back to the oldest open tax year. In fact, they went back to 1969 in our case, and are pushing it back to that timeframe.

We are aware of other companies that have had it pushed back as far as 1972. We are also aware of other companies that have open tax years in early and mid-1970's, and the Service has allowed them to start the accounting change in 1979. So there is complete inconsistency in the Service at the present time.

In the statement filed by Treasury they have indicated that taxpayers can get the benefit of a 10-year spread forwarded from 1979, but that is only if the IRS does not apply it retroactively prior to 1979 which they are doing. We feel many taxpayers are going to get a surprise after they file on September 15 when they get retroactive application.

We propose that S. 2805 be amended to conform to H.R. 7704 to provide relief to all taxpayers.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir.

[The prepared statement of Mr. Carter follows:]

Remarks Before the Subcommittee on Taxation
and Debt Management, U. S. Senate Committee on Finance

I am Charles M. Carter, Senior Vice President, Treasurer, and Chief Legal Officer of Stewart-Warner Corporation, Chicago, Illinois, and with me is Jack C. Morrison, Controller of Stewart-Warner.

S. 2805 - Revenue Ruling 80-60

We are appearing here today on behalf of Stewart-Warner as well as all affected taxpayers to comment upon, and to suggest changes to, Senate Bill S. 2805, a bill to provide that Revenue Ruling 80-60 shall not require a change in the taxpayer's method of accounting for taxable years beginning before 1980. We are proposing that subparagraph (c) of S. 2805 be amended to prevent punitive measures and inequities being imposed upon taxpayers. Specifically, our concern is the retroactive application of Revenue Ruling 80-60 by the Internal Revenue Service (IRS) to open tax years prior to January 16, 1979 (the date of the Supreme Court decision in the Thor Power Tool Company case which gave rise to Revenue Ruling 80-60 and Revenue Procedure 80-5 covering this subject).

We support the basic premise of S. 2805 but feel it presently falls short of providing adequate relief to all taxpayers. Pursuant to subparagraph (c), taxpayers who are affected by

Section 3.06 of Revenue Procedure 80-5 are excluded from the relief provided by this bill.

Revenue Procedure 80-5 - Section 3.06 - Retroactive Application by IRS

Revenue Procedure 80-5 provides a procedure for taxpayers to change their method of accounting for excess inventory. The procedure is granted and is mandatory for the first taxable year ending on or after December 25, 1979. However, pursuant to Section 3.06 of this Revenue Procedure, the procedure does not apply to taxpayers who have used the method of accounting now deemed impermissible and with whom the issue has been raised or is pending as of February 8, 1980 in connection with the examination of such taxpayer's tax return by the IRS. For such excluded taxpayers, the change in accounting can be applied retroactively to the oldest open tax years of the taxpayers. The impact of the exclusion is as follows:

(1) It negates or restricts the benefit of the ten-year spread granted for paying taxes pursuant to a change in accounting procedures since the start date for the ten-year spread can be pushed back to the oldest open tax year.

(2) It allows for the assessment of retroactive interest again back to the oldest open tax year.

Since the issue of the method of accounting now deemed impermissible was not finally resolved until the Thor Supreme Court decision on January 16, 1979, we consider any retroactive application prior to

such date to be punitive and inequitable. Additionally, we are concerned about the inflationary impact of such retroactive application and its affect on the international competitiveness of industry. Clearly, industry will be forced to raise prices to cover the cost of retroactive interest charges and to cover the cost impact of losing full benefit of the ten-year spread for paying such taxes.

At this point, I want to make it clear that we are not attempting to overturn the Thor decision or in any way modify such decision. We accept the decision and acknowledge our tax obligations pursuant to the change in accounting procedures --- this means that the taxes themselves are agreed upon. What we are objecting to is the retroactive interest and the negating of the ten-year spread for an accounting change. S. 2805 with the amended subparagraph (c) which we propose will leave stand the full impact of the Supreme Court decision but will preclude the imputing of retroactive punitive sanctions. We suggest this will allow for equitable application of the Supreme Court decision.

Senator Nelson's Observations

In introducing the bill in question, Senator Nelson recognized the problem of retroactive application when he stated in the Record, "The retroactive application on Revenue Ruling 80-60 may impose significant tax liabilities on many taxpayers because of the one-time adjustment which they must make for past excessive inventory

write-downs." He recognized that some taxpayers were unaware of the Thor decision and that others were counselled to not make any accounting changes until the IRS issued regulations or rulings implementing the Supreme Court decision. (As a matter of fact, the IRS itself was advising taxpayers the national office would be issuing guidelines or rulings to implement the decision and required accounting changes.) He stressed that retroactive application of Revenue Ruling 80-60 to tax year 1979 was inappropriate since the Revenue Ruling was not issued until February 1980. However, it does not appear that Senator Nelson appreciated the retroactive aspects which would extend the matter back beyond the date of the Supreme Court decision since subparagraph (c) as now presented allows for such retroactive application for those affected by Section 3.06 of Revenue Procedure 80-5.

House Bill Incorporating Amended Subparagraph (c)

A companion bill H.R. 7390 was introduced in the House by Congressman Conable. Congressman Conable has since introduced a new bill H.R. 7704 in place of H.R. 7390 and the new bill incorporates the language in subparagraph (c) which we propose be incorporated into S. 2805. We commend Congressman Conable for taking such positive action on this point.

Background Information

It might be helpful to supply you with some background information on this subject. At issue in the Thor case was the

method of accounting for excess inventory. The method employed by Thor which was deemed impermissible by the Supreme Court in 1979 had been employed by many taxpayers for a number of decades. While the IRS had previously challenged such method, it ultimately accepted such method until the Thor case. For example, Stewart-Warner had this method challenged in the mid-1950s and the IRS accepted our method of accounting in conference. It was not until 1976 (some 20 years later), when the IRS was auditing Stewart-Warner's tax years of 1972-73, that the IRS again challenged this method of accounting.

The Thor challenge arose in the latter 1960s during an audit for taxable years 1963-65. A lawsuit was filed in the Tax Court in 1969 challenging the IRS rejection of the old, standard method of accounting for excess inventory. The Tax Court rendered a decision in favor of the IRS on May 6, 1975. This was affirmed by the U.S. Court of Appeals on September 28, 1977. It was not until October 11, 1977 that the IRS issued Revenue Ruling 77-364 clarifying their position on the method of accounting on excess inventory. The IRS had not previously taken an official position on this subject (except in the Thor litigation) and had not previously issued any Revenue Rulings or Procedures. Thus, it was more than 20 years after the mid-1950 withdrawn challenge to Stewart-Warner, more than eight years after the Thor litigation and subsequent to the Court of Appeals affirmance of the Tax Court decision, before the IRS officially went on record on this subject. As referenced previously,

the Supreme Court rendered its decision on January 16, 1979 at which time a final decision was issued.

Subsequent to the Supreme Court decision, Stewart-Warner filed for a change in method of accounting for excess inventory to conform to such decision. The IRS has pushed the matter back to our oldest open tax year and has assessed retroactive interest. While the matter is presently under protest, we are a direct example of the IRS's efforts to apply the Supreme Court decision retroactively and to impute punitive and inequitable sanctions. Once again I stress, we are not opposed to paying the taxes due but object to the retroactive interest and loss of full benefit of the ten-year payment spread.

We feel that many taxpayers are unaware of the retroactive application by the IRS which we, unfortunately, have already experienced. As referenced previously, Revenue Procedure 80-5 provides for changing the method of accounting for excess inventory for the first taxable year ending on or after December 25, 1979. Most corporate taxpayers obtain extensions for filing their tax returns and the last extension for 1979 for those on a calendar year expires September 15, 1980. Accordingly, those taxpayers will be filing with the accounting change on September 15, 1980. It will be subsequent to that date that affected taxpayers will become aware of the retroactive application by the IRS - we submit, much to their surprise, particularly in this recessionary time.

<u>Amendment of S. 2805 Required to Prevent Punitive, Inequitable and Inflationary Sanctions</u>

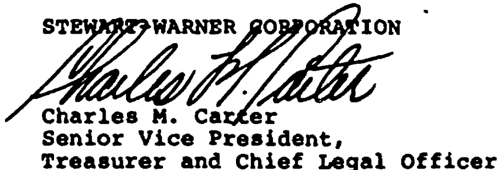
In conclusion, we respectfully submit that equitable relief is in order for all taxpayers affected by this change in method of accounting to prevent punitive, inequitable and inflationary sanctions by the IRS through retroactive application of the Thor Supreme Court decision. To those who were unaware of the issue and didn't have it raised by the IRS before February 8, 1980, we concur with the language in the bill making the change only for taxable years beginning after December 31, 1979. For those who had the issue raised by the IRS, we suggest the change should be made only for taxable years beginning after January 16, 1979, the date of the Thor Supreme Court decision. We propose that S. 2805 be amended as follows to conform to H.R. 7704 and that it be voted out of this Subcommittee in such amended form:

> "(c) For a taxpayer to whom Revenue Procedure 80-5 does not apply by reason of Section 3.06 thereof, such taxpayer shall be required to make such change in method of accounting only for taxable years beginning after January 16, 1979."

We appreciate the opportunity to appear before this Subcommittee and appreciate your kind attention to our presentation.

Respectfully submitted,

STEWART-WARNER CORPORATION



Charles M. Carter
Senior Vice President,
Treasurer and Chief Legal Officer

Jack C. Morrison
Controller

Senator BYRD. Mr. Roche, if you will proceed, this will conclude the panel.

STATEMENT OF THOMAS ROCHE, LEGAL COUNSEL, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. ROCHE. Mr. Chairman, I am Thomas Roche of the law firm of Halfpenny, Hahn & Roche, legal counsel to the National Association of Wholesaler-Distributors. I, too, would highlight my statement and ask that the entire statement be included in the record.

Senator BYRD. Very well.

Mr. ROCHE. NAW is a federation of 116 national commodity line associations which in turn are composed of over 45,000 merchant wholesaler-distributors located throughout the 50 States.

The capital formation crisis is of major concern to almost all of the commodity lines represented. We thus sincerely appreciate the subcommittee inviting us to appear in support of S. 2805.

With the devastating impact of inflation on our economy and the likelihood that we will continue to live in an inflationary economy into the foreseeable future, and since the release of Revenue ruling 80-60, inventory-intensive business is being forced to reexamine its method of inventory accounting.

The retroactive effect of Revenue ruling 80-60, not being issued until February 1980, but effective for the calendar year 1979, is causing great hardship to business by severely distorting their 1979 income.

The proposed spread of the impact over 10 years allowed by Revenue procedure 80-5 does not grant sufficient relief to offset the effect of being closed out of adjusting their inventories by use of one or both of the permissible methods before the end of calendar year 1979.

Had Revenue ruling 80-60 been issued prior to the close of calendar year 1979, previous impermissible write-downs could still have been restored to the beginning 1979 inventory. If after an analysis of that inventory the wholesaler-distributor in fact had obsolete or otherwise substandard inventory, it could have scrapped or made the requisite offering, thus, in effect, beginning its post-*Thor* inventory in full compliance with current IRS procedures.

Not having that opportunity to properly adjust coupled with the corresponding obligation to restore, substantially distorts income in favor of the Treasury in an identical manner that the Court found the taxpayer distorting income in its favor in the *Thor* decision.

After the *Thor* decision, during the period beginning January 1, 1979, through December 31, many competent and informed certified public accounting firms, individual accountants, and consultants were advising business not to change their inventory accounting method by restoring previous inventory write-downs.

Some held that such a change would constitute a change of accounting method that would require permission of the Commissioner, others that *Thor* did not apply to obsolescence in a wholesaler-distributor inventory and others simply advised waiting until the IRS articulated its position on inventory write-downs subsequent to the *Thor* decision.

All of this advice was given in good faith and when no *Thor* pronouncement was issued during calendar year 1979, tax counsel throughout the country felt secure in their position that any *Thor* adjustments to inventory would be required to the 1980 or later inventory rather than 1979.

As Justice Blackmun stated: "The taxpayer cannot take its cake and eat it, too," neither should the Treasury have its cake and eat it, too, by requiring the restoration while foreclosing permissible adjustments.

As tax counsel for the National Association of Wholesaler-Distributors, we met with representatives of the Internal Revenue Service in Washington in June. The meeting lasted approximately 2½ hours, and was conducted on an informal basis.

During the course of the meeting, the Service and NAW discussed the relative merits of their respective positions. The Service

and Treasury forcefully advocated their position on the issuance of Revenue ruling 80-60 and Revenue procedure 80-5 in February, and would not concede that the ruling was retroactive or had any retroactive effect.

We equally as forcefully stated that the Service was refusing to recognize the business atmosphere relative to inventory write-downs that existed at the time of *Thor,* and that taxpayers were not only justified, but in fact relied on competent advice that they wait for a pronouncement from IRS before adjusting their inventory based upon the *Thor* decision.

It became obvious, however, that relief was not going to come from the Internal Revenue Service, and if there was going to be relief it must come from Congress. Senator Nelson, chairman of the Senate Small Business Committee, and a member of the Senate Finance Committee, recognizing the seriousness of the impact of the retroactive effect of Revenue Ruling 80-60, introduced S. 2805 in the Senate.

Congressman Conable introduced H.R. 7390 in the House for himself, Congressman Frenzel, and Congressman Edwards, and H.R. 7704 for himself.

S. 2805 will rectify the unjust retroactive effect of the *Thor* ruling and deserves your support. Time is running, however, and we urge immediate action on this most important bill.

We thank the committee for the appointment to appear here today and express the concerns of the members of the National Association of Wholesaler-Distributors over the adverse impact of current Treasury regulations on their inventory accounting practices. These are troubled times indeed, and small business cannot continue to bear the brunt of inflation and taxation, and survive.

Senator BYRD. Thank you.

Senator Nelson.

Senator NELSON. I am looking at the Treasury's statement on page 21——

Senator BYRD. If the Senator would yield at that point, Treasury had no objection to S. 2775, S. 2818, S. 2904, and parts of H.R. 7171. Treasury does oppose S. 2805, which is your bill, which is being testified on now.

Senator NELSON. The question I was going to ask for a response from the panel on that statement on page 21 of the Treasury's testimony in which they say:

> Further, taxpayers can still scrap or offer for sale their excess inventory during 1980 and receive the tax benefits of a realized loss. But, it has been answered, this would be a year later. That argument is more form than substance since, while the full loss would be recognized in 1980, only one-tenth of the income adjustment would be recognized in 1979. We do not believe that these taxpayers suffer any significant detriment for losing the benefits of deferral of one-tenth of the adjustment for one year, especially when it is weighed against the benefits deferral these taxpayers have received during all of the years that the improper method was used.
>
> We also have serious doubts as to whether the taxpayers advancing this argument would have actually scrapped the inventory before the end of 1979. Whether to scrap would still be a decision based in large part on nontax, business considerations.

Do you have a response to that?

Mr. ROCHE. Senator, may I respond to that? I think it bears on the chairman's previous question also.

I think that that is a spurious argument. What we are concerned with is substantial distortion of 1979 income by requiring the restoration in 1979 without giving the taxpayer an opportunity to reduce the effect of that impact initially. We think that this is a 1979 tax issue. Although the argument that the taxpayer could scrap in 1980 and gain somewhat of a benefit—I don't grant that a benefit is gained by scrapping in 1980 when, in effect, you could lessen the impact of the distortion to your income in 1979 by giving the opportunity to make that same adjustment in the year in which it should be made.

If we are going to make the restoration, we should be entitled to make the corresponding adjustments using a permissible method. It is that from which we are foreclosed. The fact that we get a side benefit somewhere along the line, theoretically, by being able to scrap it in 1980, I think is a spurious argument.

This is a 1979 tax issue. The year in which the restoration was made is the year in which we should be allowed to make the adjustment. Opinion as to whether a taxpayer is going to do something or not, I don't think is relevant.

Mr. CARTER. Senator, could I add something to that.

While they point out that there is a 10-year spread beginning in 1979, as I raised in your absence, the IRS is applying it retroactively to any open tax years for many taxpayers, and in our case back to 1969, such that there is no 10-year spread. There is no benefit at all to us and to many taxpayers that they are going retroactively beyond 1979. So the Treasury is talking out of their mouth, and IRS is applying it in a different fashion.

Senator NELSON. Thank you.

Senator BYRD. Thank you, gentlemen.

[The prepared statement of Roche follows:]

Statement of Thomas F. Roche, Legal Counsel, National Association of Wholesaler-Distributors, Halfpenny, Hahn & Roche, Chicago, Ill.

I am Thomas F. Roche of Halfpenny, Hahn & Roche, Legal Counsel to the National Association of Wholesaler-Distributors (NAW).

NAW is a federation of 116 national commodity line associations (Appendix I) which in turn are composed of over 45,000 merchant wholesaler-distributors located throughout the 50 states.

The capital formation crisis is of major concern to almost all of the commodity lines represented. We thus sincerely appreciate the Subcommittee inviting us to appear in support of S.2805.

The Wholesale Distribution Industry

Wholesale distribution is a major factor in the United States economy, with sales forecast by the U.S. Department of Commerce to reach just short of $1 trillion this year. The industry provides employment to over 4.2 million individuals. Our membership accounts for approximately 60% of industry sales, and employment.

NAW members distribute virtually every conceivable type of consumer and industrial product. They purchase goods from manufacturers and resell them to retailers and to industrial, institutional, commercial and other types of business users, as well as to government. It is an inventory intensive business.

Despite the impressive aggregate statistics cited above, the wholesale distribution industry is preponderantly composed of small-to-medium-sized businesses. The average NAW member's sales volume is less than $5,000,000, he has less than 50 employees. It is through this size of business that the vast bulk of products move to market in our economy.

THOR Ruling (Rev. Rul. 80-60)

With the devastating impact of inflation on our economy and the likelihood that we will continue to live in an inflationary economy into the foreseeable future and since the release of Rev. Rul. 80-60 (Thor Ruling), inventory intensive business is being forced to re-examine its method of inventory accounting.

The "Retroactive" effect of Rev. Rul. 80-60 (not being issued until February, 1980, effective for calendar year 1979) is causing great hardship to business by severely distorting their income in 1979.

The proposed spread of this impact over 10 years allowed by Rev. Proc. 80-5 does not grant sufficient relief to offset the effect of being closed out of adjusting their inventory by use of one or both of the permissable methods before the end of calendar year 1979.

Had Rev. Rul. 80-60 been issued prior to the close of calendar year 1979, previous impermissible write-downs could still have been restored to the beginning 1979 inventory. If after an analysis of its inventory the wholesaler-distributor in

fact had obsolete or otherwise sub-standard inventory, it could have scrapped or made the requisite offering, thus in effect, beginning its post THOR inventory in full compliance with current I.R.S. procedures. Not having the opportunity to properly adjust coupled with the corresponding obligation to restore, substantially distorts income in favor of the Treasury in an identical manner that the Court found the taxpayer distorting income in its favor in the THOR Decision.

After the THOR Decision, during the period beginning January 1, 1979 through December 31, 1979, many competent and informed certified public accounting firms, individual accountants and consultants were advising business not to change their inventory accounting method by restoring previous inventory write-downs.

Some held that such a change would constitute a change of accounting method that would require permission of the Commisioner, others that THOR did not apply to obsolesence in a Wholesaler-Distributor inventory and others simply advised waiting until I.R.S. articulated its position on inventory write-downs subsequent to the THOR Decision.

All of this advice was given in good faith and when no "THOR" pronouncement was forthcoming during calendar year 1979, tax counsel throughout the Country felt secure in their position that any "THOR" adjustments to inventory would be required to the 1980 or later inventory rather than 1979.

As Justice Blackmun stated, "the taxpayer can not have

its cake and eat it too", neither should the Treasury "have its cake and eat it too" by requiring the restoration while foreclosing permissable adjustments.

As tax counsel for the National Association of Wholesaler-Distributors, we met with representatives of the Internal Revenue Revenue Service in Washington, D.C. on June 19, 1980.

The meeting lasted approximately two and one-half hours and was conducted on an informal basis. We agreed at the outset that the respective positions of the Service and of NAW would be as set forth in our letter requesting the conference and the Service's response to the inquiry of Senator Burdick, copies of which are attached to this statement as Exhibits A and B for your information.

During the course of the meeting, the Service and NAW discussed the relative merits of their respective positions. The Service and the Treasury forcefully advocated their position on the issuance of Rev. Rul. 80-60 and Rev. Proc. 80-5 in February of 1980, and would not concede that the ruling was retroactive or had a retroactive effect. As stated in their letter, they believe that the effect of Rev. Rul. 80-60 and Rev. Proc. 80-5 was mandated by the Supreme Court in January 1979 and taxpayers indeed had the entire calendar year of 1979 to make the required restoration and allowable adjustments.

We equally as forcefully stated that the Service was refusing to recognize the business atmosphere relative to inventory writedowns that existed at the time of Thor and that taxpayers

were not only justified, but in fact, relied on competent advice that they wait for a pronouncement from IRS before adjusting their inventory based upon the Thor decision.

It became obvious, however, after two hours of discussion that we had reached a stalemate and that the Service would not consent to make Rev. Rul. 80-60 and Rev. Proc. 80-5 applicable to years beginning after December 31, 1979. Relief must come from Congress.

Senator Nelson, Chairman of the Senate Small Business Committee and a member of the Senate Finance Committee recognizing the seriousness of the impact of the retroactive effect of Rev. Rul. 80-60 introduced S.2805 in the Senate. Congressman Conable introduced H.R. 7390 in the House for himself, Congressman Frenzel and Congressman Edwards and H.R. 7704 for himself. S.2805 will rectify the unjust retroactive effect of the THOR Ruling and deserves your support. Time is running, however, and we urge immediate action on this most important bill.

We thank the Committee for the appointment to appear today and express the concern of the membership of the National Association of Wholesaler-Distributors over the adverse impact of current Treasury regulations on their inventory accounting practices. These are troubled times indeed and small business cannot continue to bear the brunt of inflation and taxation, and survive.

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PLEASE REFER TO
OUR FILE NO.

May 15, 1980

Hon. Jerome Kurtz
Commissioner of Internal Revenue
Internal Revenue Service Building
Room 3000
Washington, D. C. 20224

Commissioner Kurtz:

We represent the National Association of Wholesaler-Distributors. NAW is a federation of 115 national commodity line associations which in turn are composed of over 40,000 merchant wholesaler and distributor establishments located throughout the 50 states. Wholesale distribution is a major force in the United States economy, with sales forecast by the U.S. Department of Commerce to exceed $825 billion this year. The industry provides remarkably stable employment to over 4.2 million individuals.

The "Retroactive" effect of Rev. Rul. 80-60 (not being issued until February, 1980, effective for calendar year 1979) is causing great hardship to our members by severely distorting their income in 1979.

The proposed spread of this impact allowed by Rev. Proc. 80-5 does not grant sufficient relief to offset the effect of being closed out of adusting their inventory by use of one or both of the permissable methods before the end of calendar year 1979.

Had Rev. Rul. 80-60 been issued prior to the close of calendar year 1979, previous impermissible write-downs could still have been restored to the beginning 1979 inventory. If after an analysis of its inventory the wholesaler-distributor in fact had obsolete or otherwise sub-standard inventory, it could have scrapped or made the requisite offering, thus in effect, beginning its post THOR inventory in full compliance with current I.R.S. procedures. Not having the opportunity to properly adjust coupled with the corresponding obligation to restore, this substantially distorts income in favor of the Treasury in an identical manner that the Court found the taxpayer distorting income in its favor in the THOR Decision.

Hon. Jerome Kurtz
Washington, D. C. 20224

May 15, 1980
Page Two

After the THOR Decision, during the period beginning January 1, 1979 through December 31, 1979, many competent and informed certified public accounting firms, individual accountants and consultants were advising business not to change their inventory accounting method by restoring previous inventory write-downs.

Some held that such a change would constitute a change of accounting method that would require permission of the Commisioner, others that THOR did not apply to obsolesence in a Wholesaler-Distributor inventory and others simply advised waiting until I.R.S. articulated its position on inventory write-downs subsequent to the THOR Decision.

All of this advice was given in good faith and when no "THOR" pronouncement was forthcoming during calendar year 1979, tax counsel throughout the Country felt secure in their position that any "THOR" adjustments to inventory would be required to the 1980 or later inventory rather than 1979.

As Justice Blackmun stated, "the taxpayer can not have its cake and eat it too", neither should the Treasury "have its cake and eat it too" by requiring the restoration while foreclosing permissable adjustments.

Accordingly, we request that you make the effective date of the restoration required by Rev. Rul. 80-60 January 1, 1981, thus giving our members and all businesses similarly affected calendar year 1980 to analyze their inventory and make adjustments to it before December 31, 1980 through the use of a permissable method.

On behalf of National Association of Wholesaler-Distributors, we respectfully request a meeting with you to discuss our position and the impact of Rev. Rul. 80-60 on our members as outlined in this letter.

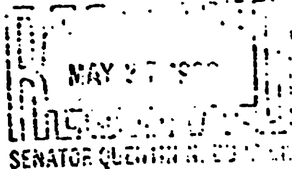
Respectfully,

HALFPENNY, HAHN & ROCHE,
on behalf of National Association of
Wholesaler-Distributors

By:

The Honorable Quentin N. Burdick
United States Senate
Washington, DC 20510

Person to Contact:
Mr. Joseph M. Jordan
Telephone Number:
202-566-4245
Refer Reply to:
T:C:C:3:4
Date:
20 MAY 1980



Dear Senator Burdick:

This is in reply to your letter, dated May 5, 1980, in which you enclosed a copy of a letter that you received from one of your constituents, Mr. Prentiss H. Cole, President of Fargo Paper Company, North Fargo, North Dakota. Mr. Prentiss believes that implementation of Rev. Rul. 80-60, 1980-10 I.R.B. 5 should not be retroactive to the 1979 tax year and you have requested more information on the ruling as well as the reasons the ruling was made retroactive for 1979 business tax returns.

Rev. Rul. 80-60 was initially issued in News Release IR-80-19, dated February 8, 1980. The ruling provides that taxpayers using a method of inventory valuation not in accordance with the decision of the Supreme Court of the United States in the case of Thor Power Co. v. Commissioner, 439 U.S. 522 (1979), 1979-1 C.B. 167, must change their method of accounting to comply with this decision for their first taxable year ending on or after December 25, 1979. In order to implement the decision of the Supreme Court, Rev. Proc. 80-5, 1980-10 I.R.B. 15, republished in 1980-17 I.R.B. 23, provides administrative rules to aid taxpayers in complying with this decision that was issued January, 1979. The republication reflects amendments announced in News Release IR-80-48, dated April 8, 1980. Rev. Proc. 80-5 was also initially issued in News Release IR-80-19.

The Thor Power Tool Co. case affirmed the method of accounting for inventory valuation established under the Income Tax Regulations when the lower of cost or market method under section 1.471-4 is applicable. In using the lower of cost or market method, the regulations require a taxpayer having "excess" inventory to value such "excess" inventory at replacement cost (if lower than actual cost as defined in section 1.471-4 of the regulations) unless the goods have been scrapped, or they have been sold or offered for sale (at a lower price) within the meaning of the regulations under section 471 of the Internal Revenue Code of 1954.

The second part of your request deals with the retroactivity of Rev. Rul. 80-60. Section 7805(b) of the Code provides that the Secretary shall prescribe the extent, if any, to which any ruling will be applied without retroactive effect. Therefore, under section 7805(b), all rulings would be applied retroactively unless the Secretary provides otherwise. As mentioned previously, the Thor decision was announced in January, 1979, and the Court concluded that the method of accounting used in Thor by the taxpayer was not proper. Therefore, based solely on the Thor decision, taxpayers would have been required to change their accounting methods at least as early as the 1979 taxable year. This is what Rev. Rul. 80-60 and Rev. Proc. 80-5 were intending to achieve - a uniform mechanism for making Thor type inventory changes beginning with 1979. Rev. Proc. 80-5 and Rev. Rul. 80-60 are not, in most instances, being applied retroactively prior to the Thor decision but rather apply to the year the decision was announced. We did not believe that the Service or taxpayers should disregard a decision of the Supreme Court of the United States by making the Revenue Ruling and Revenue Procedure apply commencing in 1980 - one year after the Thor decision was rendered.

While we are concerned with the problems Mr. Prentiss has raised regarding the effective date of Rev. Rul. 80-60, we do not believe that an extension of its effective date is warranted at this time. In our deliberations prior to the publication of Rev. Rul. 80-60 and Rev. Proc. 80-5, we considered the impact that these publications would have and firmly believe that taxpayers would have sufficient lead time to make Thor type changes if the Revenue Ruling and Revenue Procedure were effective for the 1979 calendar taxable year. Section 6081 of the Internal Revenue Code provides for an extension of time to file a tax return and states that the Secretary may grant a reasonable extension of time to file a return, except that such extension shall not be for more than 6 months. Therefore, providing the requisite extensions are granted, a calendar year corporate taxpayer has until September 15, 1980, to make the change in method of accounting required by the Thor Power decision. Furthermore, if a taxpayer does not request an extension of time to file under section 6081 of the Code, section 5.01 of Rev. Proc. 80-5 provides a mechanism for making the change in method of accounting through the use of an amended tax return. Thus, a calendar year corporate taxpayer has until September 15, 1980 (October 15, 1980 in the case of a sole proprietor or partnership) to make the change in method of accounting. This will give corporate taxpayers 8½ months (9½ months for sole proprietors and partnerships) after the end of their taxable year in which to comply with the Supreme Court decision and Rev. Proc. 80-5.

We wish to thank you for your interest and concern in this matter and hope the above information is helpful to you in responding to Mr. Prentiss.

Sincerely yours,

Chief, Corporation Tax Branch

Enclosures
Rev. Proc. 80-5 (Republication)
Rev. Rul. 80-60

Mr. SNYDER. In the interest of saving time, the Shoe Retailers Association requested that I submit for the committee record their testimony in favor of S. 2805.

Senator BYRD. It will be received.

[The prepared statement of Mr. Shell follows:]

NATIONAL SHOE RETAILERS ASSOCIATION,
New York, N.Y., July 29, 1980.

Re S. 2805.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Washington, D.C.

DEAR SENATOR BYRD: This statement is submitted by the National Shoe Retailers Association for consideration by your Subcommittee durings its deliberations on S. 2805, a bill introduced by Senator Gaylord Nelson to make prospective the rules announced by the Internal Revenue Service in Revenue Ruling 80-60.

NSRA is a national organization whose more than 3,000 company members operate more than 12,000 retail shoe outlets across the country.

In announcing this implementing procedure to the Supreme Court decision in *Thor Power Tool Co.* v. *Commissioner,* decision, but then made the ruling retroactive to tax years ending on or after December 25, 1979.

Those retailers whose fiscal years ended between Christmas Day and the date of the IRS announcement in early February had no opportunity to adjust their accounting procedures to comply with the ruling.

Senator Nelson's bill and a companion measure in the House (H.R. 7704) would provide equity to the many small retailers who are affected by Revenue Ruling 80-60 by making its application prospective, thereby giving these retailers the opportunity to adjust their marketing, sales and inventory accounting practices to comply with the IRS determination.

There is some urgency in adoption of this legislation, since retailers have only until September 15, 1980, to elect the changes which have been, in effect, forced on them by this Revenue Procedure. NSRA urges adoption of S. 2805 by that date; if it cannot be passed in time, we urge inclusion of an amendment which would require the IRS to promptly return any tax paid as a result of compliance with Revenue Ruling 80-60.

Sincerely,

JOSEPH J. SHELL, *President.*

Senator BYRD. The committee will stand in adjournment until 9 a.m., tomorrow morning.

[Whereupon, at 12:05 p.m. the subcommittee adjourned, to reconvene at 9 a.m., Tuesday, August 5, 1980.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL-CIO wishes to go on record in opposition to S. 2967.

The major feature of the bill is an increase in the "unified credit" from the present $42,500 level to $155,800 over the next 5 years. Increasing the credit by such an amount would result in:

1. No estate and gift tax return would have to be filed unless the value of the estate is over $500,000. At present an estate and gift tax return must be filed if the value of the estate exceeds $161,000
2. Only four-tenths of 1 percent of decedents' estates would be subject to any estate and gift tax.
3. The revenue loss to the Treasury Department would exceed $4 billion annually. An amount equivalent to a 70 percent slash in current estate and gift tax receipts.

We find no justification for any increase in the filing threshold particularly since the present threshold was the "quid pro quo" for a 1976 reform provision, "carryover basis." That provision would have substantially trimmed the glaring income tax loophole which allows complete tax exemption on capital gains which are passed on at death. The 1976 "carryover basis" provision never went into effect because of Congressional postponements and subsequent repeal as part the the Windfall Profits Act of 1980.

The bill would also provide for an unlimited marital deduction. Present law allows an unlimited deduction on the first $100,000 and 50 percent of any additional value of the estate. We do feel that it is appropriate tax policy to differentiate between a surviving spouse and other heirs and there is merit to an unlimited marital deduction. Such a measure should be considered but at a time when Congress is undertaking major structural reforms in estate and gift tax legislation.

The remaining sections of S. 2967 are essentially attempts to relieve burdens on smaller, closely held businesses, through liberalizing valuation criteria and extending time for payment of taxes. We agree that small closely held businesses, family farms and the like, should be protected from "forced sale", liquidation or other hardship situations. However, in our opinion, present law exclusions, exemptions, extended payment and special valuation procedures provide adequate protection.

The AFL-CIO, therefore, urges rejection of S. 2967.

ALUMINUM COMPANY OF AMERICA,
Pittsburgh, Pa., August 11, 1980.

Re S. 2775, to clarify tax treatment of retirement plans contributions made by U.S business primarily to provide benefits for foreign employees.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: I am writing to express Alcoa's support for S. 2775. Such a provision is needed in order to insure foreign approval for plans of U.S. branch corporations covering persons substantially all of whom are nonresident aliens.

Titles I and IV of ERISA exempt from coverage by those titles plans maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens. Alcoa has experienced difficulty with certain of its U.S. subsidiaries' foreign branch operations in obtaining foreign, local approvals for plan provisions that are required by ERISA in order for the companies to take U.S. tax deductions for the amounts contributed. For instance, in the situation of a Jamaican branch plan, the Jamaican taxing authorities have objected to provisions, such as the limitation of contributions and benefits, which are specifically required to appear in the plan under ERISA. We strongly believe that the tax rules in title II should not restrict a company's ability to obtain the foreign local approvals needed for such plans.

It is our understanding that the exemptions found in title I and title IV or ERISA are not in title II because it was thought that such plans would have no need to seek tax qualification. That is clearly not the case when U.S. Branch operations are involved.

We have been working with the Jamaican taxing authorities for almost four years to obtain Jamaican approval for plans containing provisions which allow them to be treated as qualified under U.S. law and meet the deductibility tests under section 404(a)(4) of the Internal Revenue Code. We believe that adoption of S. 2775 would not only provide for a current Jamaican income tax deduction for the corporation but also insure that the Jamaican nationals covered by the plans are not taxed currently in Jamaica on such contributions.

We thank you for your consideration of this matter. We request that this letter be made part of the record at the hearings on S. 2775. If we can be of any assistance or provide any further information, please do not hesitate to let us know.

Very truly yours,

ALBERT E. GERMAIN,
General Manager of Taxes.

AMERICAN STANDARD INC.,
New York, N.Y., August 1, 1980.

Re S. 2775—To amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: This written statement is in lieu of personal appearance at the public hearing before your committee scheduled for August 4, 1980. American Standard Inc. supports enactment of S. 2775.

American-Standard is a major worldwide manufacturer in four diversified areas: Transportation Products, Building Products, Security and Graphic Products and Construction and Mining Equipment.

The Company and its affiliates conduct manufacturing operations in more than 20 countries. American-Standard employs about 51,000 people and is owned by approximately 41,000 shareholders.

Two of the foreign countries in which subsidiaries of ours have substantial operations are Germany and Italy, in both of which large amounts are accrued annually for pensions or termination pay for employees under state-controlled or private plans which meet local requirements. In neither country is funding a requirement for tax deductibility.

The Internal Revenue Service has taken the position that in computing the foreign tax credit for German and Italian corporate income taxes deemed paid as a result of dividend remittances from these countries, the earnings and profits of the German and Italian subsidiaries are to be increased by accrued but unfunded German or Italian pension or termination pay contributions. This position results in a substantial reduction in the foreign tax credit that would otherwise be available and thus imposes a tax on their American parent corporations which is not borne by any non-American-owned enterprise doing business in Germany or Italy.

The proposed legislation would remedy this defect and restore the foreign tax credit to its intended function. We strongly support this legislation and believe it to be not only in the interest of companies similarly situated to ours, but also of the United States Government. The latter is true because, in the absence of such remedial legislation, the only effective way in which we could help ourselves would be to fund the German and Italian plans, which would increase our foreign tax credit, but at a substantial cost. This would have the undesirable consequence of reducing our dividend remittances from these countries, adversely affecting the United States balance of payments.

Very truly yours,

HENRY H. STEINER,
Vice President and Tax Counsel.

STATEMENT BY JIM BUGDEN, CHAIRMAN OF THE GOVERNMENT AFFAIRS COMMITTEE, AMERICAN SUPPLY ASSOCIATION

Mr. CHAIRMAN: The American Supply Association is pleased to have the opportunity to express its support for S. 2805, legislation which prevents the application of Rev. Rul. 80-60 for tax year 1979.

The American Supply Association is the single national organization of plumbing-heating-cooling-piping wholesalers. Our 1200 wholesale distributor member firms are in over 3000 locations throughout all 50 states. ASA members employ 70,000 people and our sector of the industry generates over $12 billion in annual sales; however, at the same time, over 80 percent of ASA member firms are family-held corporations. It is both because of our size and the nature of our business that we are particularly concerned about the effect of Rev. Rul. 80-60.

As the Committee is aware, Rev. Rul. 80-60 was issued 39 days after the end of calendar year 1979, yet is to be applied to the year 1979. This, we believe, is unfair to the many smaller companies which have been effectively precluded from the sale of excess inventories or use of the 30-day rule in 1979.

The IRS position, fairly stated, is that Thor Power Tool established the law in this area in early 1979, that taxpayers were then directed in unmistakable terms toward different accounting procedures, and that issuance of Rev. Rul. 80-60 was generally advantageous to taxpayers and should not be viewed as retroactive enforcement.

This is not true. For many years before Thor Power Tool, it was common practice to use the accounting procedures addressed in that decision. In fact, the issue was in sufficient dispute to merit the Supreme Court's consideration of the question. The IRS did not issue its revenue ruling until over one year later. During this period many accounting firms advised their clients to continue using their present method, until IRS permission was given to change to another method. While this is claimed by the Service to be a technical point, the IRS gives credence to the accounting firms' position by the very fact that blanket permission to change to new accounting methods was granted in February, 1980.

It is quite clear in looking at the tax environment after the Thor decision that, before the court decision could be adequately enforced, the IRS had to make a definitive statement and clear the air. That the IRS recognized this is evidenced by the very fact that Rev. Proc. 80-5 and Rev. Rul. 80-60 were issued. However, to make Thor apply retroactively to this period of uncertainty is a distinct injustice to

the taxpayers that relied on these accounting firms and the great many more small and independent businesspeople who were unaware of the Supreme Court's holding.

It is difficult to understand the IRS's strenuous opposition to this legislation. It amounts to loss of insubstantial revenues to the government, yet it will cost such taxpayers as ASA member firms significantly. We at ASA strongly support Senator Nelson's bill, S. 2805. Retroactive application of Rev. Rul. 80-60 is inequitable and requires a legislative solution.

Mr. Chairman. We appreciate having this opportunity to state our views on this legislation.

STATEMENT OF CITIBANK, N.A. IN SUPPORT OF S. 2775

Citibank endorses the principle of S. 2775 and strongly urges its passage. This bill would remove a serious irritant in our relationships with other countries, which understandably object to the application of U.S. tax law and rules and retirement plan policies to plans for the benefit of their citizens. At the same time, the bill would limit U.S. tax deductions to expenses in connection with bona fide retirement plans. At present, U.S. companies have only the choice of offending host countries by attempting to comply with U.S. tax law, or suffering a U.S. tax penalty in order to comply with local law on retirement plans.

As a leading global financial services company operating in many countries around the world, Citibank and its parent, Citicorp, must be sensitive to the needs and wishes of the host countries in which it operates. Citibank has endorsed the guidelines published by twenty three member nations of the Organization for Economic Cooperating and Development, which require respect for the internal objectives of host countries, and observation of the letter and spirit of local laws. Host countries are never more sensitive to these issues than with respect to the treatment of their citizens employed by foreign companies. They rightly insist that any such company observe their laws, policies and customs. These rules are fashioned to preserve and protect the culture and social institutions of each country. The authorities in these countries understandably object, as would the United States, to any attempt to impose external standards.

It is clear that most of the rules in Code Sections 401 et seq. were adopted to effectuate U.S. social policies, not to generate tax revenues. These rules are built on a foundation of assumptions such as the characteristics of the U.S. workforce, and the sources of economic support available to retired workers in the U.S. For the employer engaged in business overseas, this creates a direct conflict with local country regulation. Where a foreign country encourages, or even requires, retirement benefits, the local law will set forth how and when such benefits shall be paid by the employer, and provided for by funding that obligation. It is often not possible to comply with both foreign local law and industry practice, and the U.S. Internal Revenue Code. Thus the employer is placed on the horns of a dilemma. On the one hand, if the employer seeks to satisfy employee expectations by following local customs, or in the worst case, is compelled by local law to adopt certain specific retirement policies and follow specific rules, then the Internal Revenue Code will levy a penalty in the form of a refusal to recognize the cost of funding and paying those benefits as a deductible business expense. On the other hand, if local law does not prohibit it, and the employer establishes a retirement plan which complies with U.S. tax rules, then the employer is almost certain to be out of step with other non-U.S. employers in that country, thus generating hostility on the part of the employees and resentment on the part of government authorities who see their institutions being overridden.

S. 2775 will correct this by limiting the U.S. tax law rules applicable to retirement plans for foreign nationals to those few elements necessary to establish the bona fide character of the plan. This is all that needs to, and should, be done. If the U.S. is satisfied, as the provisions of S. 2775 would ensure, that a U.S. employer operating in a foreign country has in fact incurred an expense in connection with the employment of non-U.S. persons in that country, then the U.S. interest in the matter is ended.

CATERPILLAR TRACTOR CO.,
Peoria, Ill., August 12, 1980.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: This is to urge favorable consideration by Senator Byrd's Senate Finance Subcommittee on the foreign pension plan legislation (S. 2775).

Caterpillar is a large U.S. multinational corporation that designs, manufactures and markets earthmoving, construction and materials handling equipment and diesel and natural gas engines. It operates in 13 countries outside the U.S. through several subsidiary and affiliated corporations. At the end of 1979, Caterpillar had 89,400 employees. About 20,000 of these—most of which were foreign nationals—were employed outside the U.S.

Caterpillar has a vital interest in this legislation since it is presently engaged in a controversy with the IRS on one of the issues S. 2775 was designed to clarify. In determining the earnings and profits of our Japanese affiliate the IRS has denied a deduction for the addition to the company's accrued termination payment reserve, thereby reducing the allowable U.S. foreign tax credit (for Japanese taxes paid) on dividends received from this company, in spite of the fact that the amount accrued was just the amount necessary to increase the total reserve to the amount which would be payable to the company's employees if they had all retired voluntarily at the end of the year—the minimum the company will eventually have to pay in all events.

The IRS adjustment was made primarily because the Japanese plan did not meet the qualification requirements of U.S. tax law. It is unreasonable for the U.S. to impose its qualification standards on the retirement plans of foreign corporations in order that contributions to such plans be deductible for U.S. tax purposes. Different methods of addressing retirement pay in different countries should be recognized as valid. The liability under these foreign plans is no less real than under U.S. plan concepts, and any U.S. tax treatment which fails to recognize this fact is unrealistic and unfair.

Section 4(b)(4) of the Employee Retirement Income Security Act of 1974 (ERISA) specifically exempts foreign plans primarily for the benefit of nonresident aliens from all the requirements of Title I of that act. However no exemption of such plans from the tax provisions (Title II) of ERISA was provided, presumably because "such plans would have no need to seek tax deferral qualification." (See Conference Report 93-1280, 2nd Session, p. 291, 8/12/74.) Perhaps through oversight Congress ignored the U.S. tax deduction problems of foreign branch and subsidiary plans and the fact that they often cannot be made to comply with ERISA requirements. This has resulted in considerable uncertainty in the tax area, inequitable treatment between foreign and U.S. plans, and potential litigation.

Accordingly, Caterpillar urges that the Internal Revenue Code be amended to eliminate these tax inequities and uncertainties. With minor exception, it appears S. 2775 would accomplish that purpose; so we strongly support this legislation.

If you or the subcommittee members have any questions or would like further elaboration on any point, please call Albert C. Greer, telephone number (309) 675-4478, or write to him at Caterpillar Tractor Co., 100 N.E. Adams Street, Peoria, Illinois 61629.

Respectfully submitted,

G. A. SCHAEFER,
Vice President, Finance.

THE CONTINENTAL GROUP, INC.,
Stamford, Conn., August 25, 1980.

Subject: S. 2775—A bill relating to the treatment of retirement and similar plans of deferred compensation maintained for nonresident aliens.

COMMITTEE ON FINANCE,
U.S. Senate, Subcommittee on Taxation and Debt Management,
Washington, D.C.

GENTLEMEN: We are pleased to have the opportunity to express to you our views in support of the enactment of S. 2775, a bill which would amend the Internal Revenue Code of 1954 insofar as it governs the income tax treatment of costs attributable to retirement and similar plans of deferred compensation maintained for nonresident aliens. This written statement is being submitted in lieu of a personal appearance at the public hearing which your Subcommittee on Taxation and Debt Management held on August 4, 1980.

The Continental Group, Inc. operates worldwide with 62,000 employees engaged in packaging, natural resources and financial services businesses. We conduct overseas operations through branches, subsidiaries and associated companies. We manufacture in 18 countries outside the U.S. wherein we employ a work force of 21,000 men and women, substantially all of whom are covered by private pension plans supported by our company. As in the U.S., these private industry supported pension plans are necessary to attract and maintain a stable work force, an essential element to remaining competitive in today's worldwide marketplace.

The basic issue which S. 2775 addresses is whether, in the conduct of our foreign operations through branches, subsidiaries and associated companies, we should be required to meet the same strict tests for deductibility of costs attributable to foreign pension plans maintained for our nonresident alien employees as are applied in determining the deductibility of similar costs related to plans covering U.S. persons.

These tests applicable to plans providing benefits for U.S. employees are, in general, motivated by U.S. social and tax policy concerns which are not present in the case of foreign plans maintained for nonresident aliens. The requirement for funding through an independent trust, for example, is designed to insure the security of pension promises. This is certainly a valid concern but is one which other countries have addressed differently. The payment requirement as it applies to nonqualified plans, was designed to avoid a mismatching of expense to the corporation and income to the employee. There is no need for such a requirement where the employee is a nonresident alien because he would not be taxed on the income in the first instance.

The Internal Revenue Service has, nonetheless, taken the position in a Private Letter Ruling and in a Technical Advice Memorandum that, without regard to the motivation for the various strict tests applicable to plans covering U.S. employees, those same strict tests must be applied in the case of foreign plans covering nonresident alien employees. S. 2775 would provide a very necessary different direction in this respect. The Bill would permit U.S. taxpayer companies, in the calculation of their U.S. taxable income arising either from branch activities or from dividends, to use rules which approximate normal accrual rules for purposes of testing the deductibility of costs relating to pension plans benefiting nonresident aliens.

In light of the position of the Internal Revenue Service and absent the Congressional direction which S. 2775 would provide, we have effectively been faced with two choices:

(1) The prospect of incurring substantial nondeductible costs in order to maintain necessary pension plans for our non-U.S. employees, or

(2) The prospect of attempting to obtain qualification for plans covering these employees under the strict tests of U.S. law.

This latter alternative has really not been a practical one. The plans in question are maintained for foreign employees and are typically different for each country in which we operate, being governed by the laws of the particular foreign country having primary jurisdiction. These foreign laws do not necessarily parallel the U.S. in either motivation, theory or application. Instead, they reflect considerations of tax policy and social benefit deemed necessary to achieve the foreign jurisdiction's own goals and priorities. At best, an attempt to simultaneously meet the requirements of both U.S. and foreign law would be a difficult, time-consuming and costly process that would result in foreign plans that are not in conformity with and competitive with customary local practice. At worst, such an attempt would be fruitless because of irreconcilable conflicts.

Germany is a good example. There, the local deductibility of our substantial pension costs are assured not by the use of a U.S.-type qualified plan and related funded trust, but by an accrual of the pension liabilities on the balance sheet. German law specifies its own set of tests and criteria which must be satisfied in order to obtain the tax deduction. Funding of these pension costs in a manner strictly comparable to that employed in the U.S. is effectively discouraged. Were U.S. concepts to be strictly employed in Germany, either the employees would be taxed currently in Germany on their future pension benefits or the sponsoring subsidiary corporation would be denied a German tax deduction.

We have reluctantly pursued the former alternative, namely the prospect of incurring substantial non-deductible costs in the course of maintaining our very necessary foreign pension plans. We have done this both because the alternative is unworkable and because we operate abroad in the main part through subsidiaries and are of the opinion that the treatment for which S. 2775 would provide is arguably already available to us under Section 902 of the Internal Revenue Code with respect to dividends. This, however, has been far from a satisfactory solution

because the uncertainty created by the Internal Revenue Service position has discouraged the payment of dividends and led to what amounts to cost-mandated foreign reinvestment. Such a course of action is, in our view, counterproductive in an economic environment where not only our nation's balance of payments deficit but also U.S. industry's need for additional investment capital to stimulate the economy, should be encouraging repatriation.

We believe that no justifiable social and tax purposes are served by a policy of extending to pension plans covering nonresident alien employees the same strict tests of the Internal Revenue Code as are applicable to plans covering U.S. persons. Congress has, itself, already agreed to this point when it excluded plans maintained primarily for the benefit of nonresident aliens from Titles I and IV, Employee Retirement Income Security Act (ERISA). We believe instead that the pension methods which are deemed by foreign authorities to provide adequate protection for their own nationals should be honored and accepted by the United States.

S. 2775 has incorporated into its provisions a number of reasonable safeguards to insure that the U.S. tax treatment of foreign pension costs is not unduly influenced or controlled by foreign law. Thus, it requires that reasonable actuarial methods be used to determine pension liabilities and that U.S. generally accepted accounting principles serve as an overriding measure of limitation on the deduction which would be allowed. We support these various limitations as reasonably necessary.

For the reasons discussed above, The Continental Group, Inc. strongly endorses S. 2775 and urges its enactment. We urge this Subcommittee to report out S. 2775 favorably at the earliest possible date.

Yours very truly,

FRANCIS C. OATWAY,
Vice President, Taxation.

DEERE & CO.
Moline, Ill., August 14, 1980.

Re Foreign pension plans (S. 2775).

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

DEAR MR. STERN: We at Deere & Company have just been informed that a bill dealing with the United States taxation of foreign retirement plans has been introduced in the Senate as Bill S. 2775. The bill is identifical to House Bill H.R. 7263 that proposes to exempt foreign retirement plans maintained for nonresident aliens from U.S. taxation by exempting such plans from Title II of the Employee Retirement Income Security Act of 1974 (ERISA)—the section of ERISA which contains the ERISA amendments to the Internal Revenue Code.

It is our understanding that plans primarily for the benefit of nonresident aliens maintained outside the United States were exempted from all requirements of Title I of ERISA by Congress in Section 4(b)(4) of ERISA. However, a parallel provision exempting such plans from the requirements of ERISA was not inserted in Title II of ERISA, thus leaving a gap in the legislation with regard to foreign plans.

Notwithstanding the Title I exemption, the Internal Revenue Service has recently taken the position that a United States employer may deduct contributions to a foreign plan only if the plan is a fully qualified plan, i.e. it complies with all of the amendments to the Internal Revenue Code made by Title II of ERISA. This position was announced by the Internal Revenue Service in Private Letter Ruling 7904042.

Such a position, if warranted, places an undue burden upon United States employers. The Service, in promulgating this position, is forcing United States employers to impose United States standards on foreign pension plans maintained for nonresident aliens. Such a position ignores the complexities of international laws. Moreover, Congressional sanctioning of that position would stray far beyond the limitations of the laws of the United States.

In fact, Congress already recognized these limitations when, in first deliberating on ERISA legislation in 1974, Congress noted: "such plans—foreign pension plans—would have no need to seek tax deferral qualification". (See ERISA Conference Report, H.R. Rep. 93-1280, 93d Cong., 2d Sess. 291 (1974).)

In light of the fact that Congress had already resolved the issue in favor of foreign pension plans back in 1974, it is evident that the Internal Revenue Service has incorrectly interpreted the void in Title II of ERISA as a signal by Congress that such plans are to be subject to the Internal Revenue Code.

Accordingly, we at Deere agree with the ERISA Industry Committee that legislation such as S. 2775 be enacted to overrule any possible interpretation by the

Internal Revenue Service that such plans must conform to the requirements of ERISA in order for an employer to receive a deduction under the Internal Revenue Code for contributions made to such foreign plans.

We, therefore, request that prompt consideration be given to the passage of Senate Bill 2775.

Very truly yours,

ROBERT A. HANSON, *President.*

DRESSER INDUSTRIES, INC.,
Dallas, Tex., August 4, 1980.

Re S. 2775—To amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

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

GENTLEMEN: Dresser Industries wishes to submit this written statement in support of S. 2775.

Dresser Industries is a large international corporation that furnishes goods and services to the energy and natural resource markets. We presently employ a total of some 13,500 local nationals in our business operations in a host of foreign countries. Many, if not most of these employees, participate in local pension programs developed for such foreign employees.

As you would expect, these foreign pension plans were designed to provide benefits that are appropriate under the prevailing local situations, including local customs, laws, governmental social benefit programs and competitive considerations of the labor market. These local conditions are seldom similar to, and often are significantly different from, those prevailing in the U.S.

This fact appeared to be recognized when Congress explicitly exempted such foreign programs from the labor and insurance provisions of ERISA when that law was enacted. However—we believe essentially through oversight—such an exemption was not included in the tax provisions of ERISA. As a result, Dresser and all other companies with foreign operations are in danger of losing tax deductions for the necessary contributions to these foreign plans, since it would be impractical and sometimes impossible to conform them to ERISA requirements.

If the ERISA requirements are superimposed on all the local legal and operational requirements for each of these plans, it will result in substantial increases in our cost of doing business, either through loss of tax deductions or non-productive legal and administrative expenses of ERISA compliance. As a result, we would be at competitive disadvantage with foreign business concerns that are not saddled with such costs.

For these reasons, we strongly support enactment of S. 2775.

Very truly yours,

JOHN V. JAMES, *President.*

EMERGENCY COMMITTEE FOR AMERICAN TRADE,
Washington, D.C., August 12, 1980.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
Committee on Finance, Washington, D.C.

DEAR MR. CHAIRMAN: The Emergency Committee for American Trade (ECAT) appreciates this opportunity to comment on S. 2775, relating to the tax treatment of pension plans maintained overseas for foreign workers by U.S.-based companies. We support S. 2775 and request that this letter be made a part of the record associated with the August 4 hearing on that subject.

ECAT is an organization of 65 U.S. companies with extensive international business operations. In 1979, these companies employed nearly 5 million men and women with worldwide sales of $500 billion. Because of our members' great interest and stake in the world marketplace, we are especially sensitive to U.S. Government action which could serve to put U.S.-based international companies at a competitive disadvantage.

The need for legislation, such as S. 2775, stems from a recent Internal Revenue Service attempt to extend the application of U.S. pension policy to foreign pension plans maintained primarily for the benefit of employees who are non-resident aliens. The IRS has, in effect, ruled that such plans must meet all the tax rules applicable to plans maintained for employees resident in the U.S.

U.S. retirement policy reflected in the Employee Retirement and Income Security Act (ERISA) is a unique combination of American social, historical and economic factors. Other countries, with different circumstances, have taken other approaches to meet their particular national needs. Since these many approaches have produced widely varying national rules in providing retirement security to workers, the IRS attempt, through U.S. international companies, to export U.S. pension rules is potentially disruptive and costly to American business overseas.

S. 2775 would treat an employer's liabilities under foreign plans in the same manner as other ordinary and necessary business expenses incurred overseas. Appropriate safeguards would be provided to insure that all deductions reflect true business expenses based on generally accepted U.S. accounting principles.

The Congress has recently been correctly concerned with increasing the competitiveness of U.S. business overseas. Failure to enact S. 2775 would result in substantial financial and legal competitive disadvantages to the conduct of business overseas by U.S.-based firms. We thus urge prompt and affirmative action on S. 2775.

Sincerely,

ROBERT L. MCNEILL,
Executive Vice Chairman.

FINANCIAL EXECUTIVES INSTITUTE,
New York, N.Y., August 18, 1980.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Finance Committee, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The Committee on Taxation of Financial Executives Institute submits this statement for inclusion in the record of hearings held on August 4, 1980 on Senate bill 2775.

We strongly support enactment of S. 2775, a bill to amend the Internal Revenue Code as it applies to employee pension plans maintained primarily for the benefit of nonresident aliens. Enactment of this bill will provide for U.S. tax treatment of foreign pension expenses of plans maintained for nonresident alien employees of foreign branch offices and foreign subsidiaries of U.S. based international companies.

As applied to plans of foreign subsidiaries, this legislation essentially clarifies existing law without making fundamental changes and, therefore, should be fully retroactive. In the case of foreign branches, the bill should be retroactive to the enactment of the Employee Retirement Income Security Act of 1974 (ERISA); that Act is largely responsible for the difficulties currently being experienced by such entities.

The Internal Revenue Service has taken the position that pension plans maintained for foreign workers must meet all U.S. tax rules applicable to plans maintained for U.S. workers. Yet, U.S. pension policy, which is reflected in ERISA, applies U.S. social factors; whereas, other countries have taken into account their own particular national needs. ERISA rules were not conceived with any thought or expectation that they would apply in a foreign context. Many of the foreign country rules conflict with rules in the U.S. but still provide comparable benefits and protection of the foreign workers.

It is impossible for most U.S. based companies operating abroad to conform to both the specific U.S. tax rules and the requirements of the host foreign country.

S. 2775 would treat an employer's pension cost under foreign plans for nonresident aliens in the same manner as other ordinary and necessary business expenses incurred in the foreign branch or foreign subsidiary operations. The legislation includes safeguards against abuse in that: no deduction can exceed amounts reasonably capable of actuarial estimation; the amount charged as expense must be consistent with generally accepted accounting principles in the U.S. applicable to charging of pension costs against income; any amounts funded may not be subject to reversion to the employer prior to satisfaction of all liabilities under the plan; and deductions for unfunded plans are allowed only in respect of benefits not subject to a substantial risk of forfeiture and only if an accrual does not exceed the present value of the accrued benefits.

Additionally, the legislation will not apply to artificial arrangements established abroad in order to circumvent the rules that are generally applicable to plans maintained in the U.S.

This legislation will avoid substantial disruptive and competitive disadvantages to American business operating overseas while maintaining the reasonable intended

test for such foreign plans. Thus, our Committee urges prompt enactment of S. 2775, with appropriate effective dates.

Sincerely,

DONALD K. FRICK,
Chairman, Committee on Taxation.

STATEMENT SUBMITTED BY HEYWOOD C. GAY

Mr. Chairman and members of the committee; My name is Heywood C. Gay, Executive Vice President of the Georgia Electric Membership Corporation, the statewide association for the rural electric cooperatives in Georgia. Our member-systems serve 73 percent of the land area of Georgia with 93,000 miles of line to 700,000 meters.

Instead of appearing in person, I am submitting written testimony in favor of Senator Talmadge's bill, S. 2818, and to urge other members to support this legislation.

As you may know, an identical bill, H.R. 7520, sponsored by Representative Al Ullman, is pending in the House Ways and Means Committee. We have been successful in getting seven members of our House Delegation to co-sponsor this legislation. In addition, our Junior Senator, Sam Nunn, has become a co-sponsor of S. 2818.

This unanimous support from our Members of Congress indicates the strong feeling that exists in Georgia on this matter. Rural electric cooperatives have built pole lines that are paid for by member-consumers, with the assistance of loans from the Rural Electrification Administration. If any profit or margin is realized from electric service, it is returned to the member-consumers. We believe this is a vital public service done on a non-profit basis.

Now comes the Internal Revenue Service to say any revenue derived by these cooperatives for pole line attachments constitute unrelated business income and thus is asking the non-profit cooperative to pay taxes on this revenue. As most of you know, most of these lines are built across prairies, fields, and woods, with but few customers to the mile. If a telephone company also serves these customers it makes little economic sense to build another pole line and not jointly use the same poles. Likewise, landowners and environmentalists will rightly object to two poles where one will suffice.

Most of the alleged "unrelated business income" comes from telephone company rentals. We believe reliable telephone service is not only good for the economy of an area and helps maintain a higher standard of living, but it is also extremely important if we are to provide reliable electric service. Problems on a cooperative's distribution system or outage reports are practically all reported over the telephone. With the absence of telephone service it might be days before individual outages would be corrected. for this reason alone, we believe the Internal Revenue Service is not justified in its claim that these revenues constitute unrelated business income.

Members of the Committee, we believe the solution to this problem is a legislative one. If you approve and eventually pass this bill, it will resolve our problem. If you elect not to approve this bill we will be left with the long expensive and uncertain route of judicial relief. We have already had a taste of the judicial route and believe legislative relief makes more sense and would cost our consumers less. Our legal counsel profoundly advises us the IRS assertion is clearly illegal, but to sustain this view in the courts will be very expensive.

This is a problem that every rural electric cooperative in the country faces, but in Georgia alone, IRS is already asking 6 cooperatives to pay $171,827,00. We don't feel this is right! We don't feel it serves the public interest! Our Congressional Delegation agrees with us! And we respectfully ask for your favorable consideration of this legislation.

GENERAL ELECTRIC CO.,
Fairfield, Conn., August 25, 1980.

Re S. 2775.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Finance Committee, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: On behalf of General Electric Company, I am writing to advise you of our strong support for S. 2775, which would amend the Internal Revenue Service Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

The present provisions of the Code, as amended by the Employee Retirement Income Security Act of 1974 (ERISA), have been interpreted by the Internal Revenue Service as preventing U.S. corporations, in some situations, from *ever* obtaining a business expense deduction for contributions made to provide pensions under foreign plans. In other situations, involving foreign subsidiaries, pension costs are not allowable as deductions in determining "earnings and profits," even when such costs are tax deductible under the law of the foreign country, and this can adversely affect the amount of the U.S. parent corporation's foreign tax credits.

S. 2775 recognizes that it is neither necessary nor desirable to apply the strict rules of U.S. tax law to plans maintained abroad for nonresident aliens and eliminates the unintended hardship imposed by ERISA on U.S. corporations maintaining such plans.

Therefore, we strongly urge your Subcommittee to recommend to the full Finance Committee that it act promptly and favorably on this much needed legislation.

We request that this letter be included in the printed record of the August 4 hearing.

Very truly yours,

J. J. COSTELLO,
Vice President, Comptroller.

GROOM & NORDBERG,
Washington, D.C., August 22, 1980.

Re August 4, 1980 hearings on miscellaneous tax bills.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
U.S. Senate, Washington, D.C.

(Attention: Michael Stern, Staff Director)

DEAR MR. CHAIRMAN: This statement is submitted for inclusion in the record of the above-referenced hearings of the Subcommittee. It is filed on behalf of eight major U.S. life insurance companies: Aetna Life & Casualty, Connecticut General Life Insurance Company, The Equitable Life Assurance Society of the United States, John Hancock Mutual Life Insurance Company, Metropolitan Life Insurance Company, Phoenix Mutual Life Insurance Company, The Prudential Insurance Company of America, and The Travelers.

The purpose of this submission is to recommend that the Internal Revenue Code be amended to allow life insurance companies, banks and other U.S. financial intermediaries to invest the assets of foreign pension plans in the United States on a non-taxable basis. Its enactment generally would provide foreign pension plans with the same tax treatment as U.S. pension plans, with resulting benefits for the U.S. economy and little or no revenue loss.

Our proposal is broadly related to S. 2775, concerning the deductibility of contributions made by U.S. employers to pension plans for their non-resident alien employees, on which the Subcommittee has received testimony. Although our proposal has a different focus than S. 2775, the legal problem which our proposal would resolve is essentially identical: that the tax laws relating to retirement plans condition certain benefits on compliance with detailed U.S. standards which it is unnecessary and impractical to require of foreign pension plans benefitting non-resident alien employees.

SUMMARY

In recent years, managers of foreign pension plans maintained by large employers in industrialized foreign countries—including the United Kingdom, the Netherlands and Japan—have shown a strong interest in investing in securities of U.S. companies and U.S. real estate. The opportunity to earn attractive investment returns has been one factor in this movement. Moreover, managers of foreign pension plans consider U.S. investment as an important means of diversifying their portfolios and lessening their pension plans' dependence on the economic cycles of their home countries.

Foreign pension plans represent a potentially substantial source of additional capital for the United States. For example, the total assets of pension plans maintained by employers in the U.K., Netherlands, and Japan exceed $100 billion. However, current U.S. tax laws and treaties do not encourage foreign pension plans to invest their funds here. This is because a foreign pension plan will be subject to the same tax burdens—primarily withholding taxes, which may be as high as 30 percent—as any other foreign portfolio investor. This is the case even though U.S. pension plans are exempt from tax on their U.S. investment income, and even though the foreign pension plans are exempt from income taxes in their home

countries. Moreover, to the extent that foreign pension plans have made some U.S. investments, the structure of the Code provisions for the taxation of life insurance companies has discouraged foreign pension plans from utilizing life insurance company pension funding arrangements for this purpose relative to those offered by other U.S. financial intermediaries.

PROBLEMS UNDER PRESENT LAW

Current law exempts the investment income and gains of "tax-qualified" pension trusts and similar retirement plans from U.S. tax. As a result, a U.S. life insurance company or bank may receive funds from a domestic pension plan, invest them and ultimately repay the principal and accumulated investment income to the pension plan without the imposition of any U.S. tax. The U.S. life insurance industry currently holds more than $100 billion of the more than $300 billion in assets now held under such tax-favored retirement arrangements.

A basic policy of U.S. tax law has been to provide for equal treatment of comparable types of U.S. and foreign investors, but this policy has not been carried out in the case of pension plans. This is because the applicability of the statutory tax exemption for pension plans (secs. 401(a), 501(a) of the Code) requires compliance with detailed "qualification" requirements which largely reflect U.S. retirement income policies for U.S. workers. Foreign pension plans will rarely be in a position to conform with these extremely complex requirements many of which reflect policies that may be irrelevant to foreign pension plans and may even conflict with the retirement plan laws of their home countries. Significantly, foreign charitable and religious organizations do not have this U.S. tax problem. Foreign charitable or religious organizations may qualify under the general U.S. standards for such organizations (sec. 501(c)(3)) without much difficulty, and, thus, would be exempt from U.S. income and withholding taxes on their passive investment income under present law.

As a practical matter then, present law subjects foreign pension plans to the same tax rules that apply to foreign individual and corporate investors generally. This means that dividends, rents and most forms of interest and other investment income, except for capital gains, derived from the U.S. will be subject to a 30 percent withholding tax unless a lower rate applies under a tax treaty. Moreover, a foreign pension plan that invested in the U.S. through a life insurance company would at least indirectly be subject to tax on its U.S. capital gains, and payments made by the life insurance company may not qualify for reduced treaty withholding rates on dividends, etc. These problems generally are not shared by banks, mutual funds and others. They occur because the life insurance company tax rules are structured in such a way as to allow insurers to invest funds on a tax-free basis only for specified tax-qualified retirement arrangements.

THE PROPOSAL WOULD BENEFIT THE U.S. ECONOMY AND REFLECTS SOUND TAX POLICY

Our proposal would resolve the above problems by allowing U.S. financial intermediaries to invest the assets of foreign pension plans in the United States on a non-taxable basis and without the imposition of withholding taxes on income subsequently paid to such plans. Its enactment should, consistent with sound tax policy considerations, increase U.S. investment by foreign pension plans and produce significant benefits to the U.S. economy. Specifically:

1. The proposal would channel large amounts of foreign capital to U.S. financial institutions who are major sources of U.S. business financing. Since pension plans usually invest on a long-term basis, investments made by foreign pension plans under the proposal are likely to be more stable than some other forms of foreign investment.

2. The proposal is limited to pension plan portfolio investments where U.S.-managed financial institutions are making the actual investment decisions. Consequently, foreign pension plan investors would not be in a position to exercise control over U.S. business.

3. The Proposal would extend to foreign pension plans the same tax treatment as their U.S. counterparts with respect to the taxation of U.S. source investment income and gains. Foreign pension plans would be able to select appropriate financial intermediaries for their U.S. investments without regard to the particular U.S. tax rules that may apply at the financial intermediary level.

4. Little or no revenue loss should be involved. To the extent that foreign pension plans have or may make substantial U.S. investments on a taxable basis, it is likely that such investments have been or would be structured so as to minimize U.S. tax burdens.

We urge the Subcommittee to adopt our proposal in connection with its consideration of miscellaneous tax law changes.

Very truly yours,

THEODORE R. GROOM,
Attorney.

STATEMENT OF MARTIN LEVIN, PRESIDENT, TIMES MIRROR BOOKS

Times Mirror urges the passage of Senate Bill 2805. Congress should have an opportunity to consider the effect that Internal Revenue Service ruling 80-60 will have on the scientific and creative literature in the United States. Further, it would be unfair to require book publishers to comply with a ruling before they have had an opportunity to present to the Commissioner their reasons as to why this rule could seriously inhibit the future publication of serious books.

The Supreme Court ruling in the case of *Thor Power Tool Company* v. *Commissioner of Internal Revenue* dealt with the tax deductibility of excess machinery. Now this principle is being applied to books. Who is to judge that a book with a modest initial sale will not become saleable at some later time as changes in public tastes or events dictate? The Internal Revenue Service ruling requires the publisher sell the books on a liquidation basis or scrap them in order to establish the obsolence of the book for tax purposes. In an industry in which profits are modest or even illusory, at best, the publisher is faced with the challenge of carrying inventory at full price. If books are sold at discount soon after publication, the market for subsequent books would be seriously crippled. Buyers would wait for the inevitable "bargain price."

But there is a more important principle at stake. To destroy a book is to destroy one of the highest forms of creativity. It is to eliminate a product of today that might blossom into full flower tomorrow. In an arid intellectual climate, the publisher will stay with the "tried and true". The adventurous book will be published rarely or not at all. This applies to the scientific treatise and to the first novel as well.

To give a year to consider the consequences likely to be wrought by wholesale destruction of books would not effect a serious blow to tax revenues. If the IRS declines to reverse its position during this period in relation to books, there would be only a one year delay. The present system does not result in a tax avoidance—merely a deferral. Under the current practices when a publisher sets a lower value on his inventory and he subsequently sells the inventory at a price higher than its carrying value, the publisher will pay tax on the income earned. The Internal Revenue Service always has the opportunity to challenge the publisher's valuation procedures to be certain these practices are soundly based.

In dealing with the most fragile of commodities—intellectual, scientific and creative thought—it is in the public's interest to defer the implementation of the IRS regulation as developed from the *Thor* decision. Much will be lost by immediate implementation—but nothing will be lost by delay.

STATEMENT OF WARREN V. LUDLAM, JR., ESQ., JACKSON, MISSISSIPPI
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
REGARDING S. 2967 THE FAMILY ENTERPRISE ESTATE AND GIFT TAX
EQUITY ACT INTRODUCED BY SENATOR NELSON, SENATOR BYRD,
SENATOR WALLOP AND SENATOR EAGLETON,
SUGGESTING THAT S. 2964, INTRODUCED BY SENATOR COCHRAN,
BE INCORPORATED IN S. 2967

Submitted by
Warren V. Ludlam, Jr., Esq.,
On Behalf of Two Clients, Estates Owning
Family Farms in Copiah and Hinds Counties, Mississippi

Supported by
The American Farm Bureau Federation
The National Cattlemen's Association, and
The National Association of Realtors

August 27, 1980

Section 2032A of the Internal Revenue Code of 1954, as amended, was enacted by the Tax Reform Act of 1976 in order to avoid the forced sale of farms and small businesses by estates to pay Federal estate taxes. Subject to certain requirements, this section provides for the election of a special use valuation which allows a farm or small business to be valued on the basis of its actual use rather than its highest and best use. Through the use of the special use valuation, many estates have been able to avoid selling farms and small businesses because of lower valuations and the resulting lower estate taxes. Unfortunately, the Treasury and the Service have taken a position on the time of making the election which has caused the special use valuation to be unavailable for certain estates.

As to making the election, Section 2032A(d)(1) provides as follows:

> "(1) ELECTION. - The election under this section shall be made not later than the time prescribed by section 6075(a) for filing the return of tax imposed by section 2001 (including extensions thereof), and shall be made in such manner as the Secretary or his delegate shall by regulations prescribe."

Section 6075(a) provides that estate tax returns shall be filed within nine months after the date of the decedent's death.

Section 6081 provides that generally an extension of time for filing returns, including estate tax returns, shall not exceed six months.

Section 2001 imposes the estate tax.

Although Section 2032A was effective for estates of decedents dying after December 31, 1976, the first proposed regulations issued under Section 2032A(d)1 were not published until July 13, 1978.* As a result, the time prescribed for filing the estate tax return (determined without regard to extensions) expired for many estates before the publication of any regulations. Without the benefit of the regulations, many estates decided not to elect the special use valuation, and when the estates attempted to make the election on an amended return after publication of the proposed regulations, the Service refused to accept the election.

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*The proposed regulations have recently been finally adopted.

The following are relevant facts as to the questions involved with regard to the two estates by which we have been retained. These estates will be referred to as "The April, 1977 Estate" and "The May, 1977 Estate," these being the months in which the respective decedents died.

The April, 1977 Estate -- The decedent died on April 29, 1977, the estate tax return was filed on January 27, 1978 but 2032A was not elected, the audit of same was begun in June, 1978, the first of the 2032A proposed regulations, i.e., Section 20.2032A-8, was published on July 13, 1978, the attorney filed an amended estate tax return on which the 2032A(d)(1) election was made on September 14, 1978 (after the due date of the original return, i.e., January 29, 1978), as to which amended return (containing the 2032A(d)(1) election) on December 13, 1978 the Mississippi IRS District Director's office acknowledged a Notice of Intention to Elect and stated that an Amended Notice should be filed by January 15, 1979, which Amended Notice was filed on January 10, 1979. Thereafter, on January 26, 1979 the IRS estate tax examiner notified the attorney by telephone that IRS had determined that the 2032A (d)(1) election should have been made at the time the original estate tax return was filed on January 27, 1978, and, therefore, that the election was too late and was not effective.

The May, 1977 Estate -- The decedent died on May 13, 1977, the original estate tax return was filed on October 28, 1977,

i.e., Section 20.2032A-8, was published on July 13, 1978, the amended estate tax return on which the 2032A(d)(1) election was made was filed on August 31, 1978 (the due date of the original return was February 13, 1978), as to which amended estate tax return (on which the 2032A(d)(1) election was made) the Mississippi IRS District Director's office wrote a letter, dated December 13, 1978, in which there was acknowledged this estate's Notice of Intention to Elect and in which it was stated that an Amended Notice should be filed by January 15, 1979, whereupon the attorney prepared and filed the Amended Notice on January 10, 1979. Thereafter, on January 26, 1979 the IRS estate tax examiner notified the attorney by telephone that IRS had determined that the 2032A(d)(1) election should have been made with the filing of the original return on October 28, 1977; and, therefore, the election was made too late and was not effective.

Both estate tax returns were assigned for audit to the same estate tax examiner. One was assigned in June, 1978 and the other in July, 1978. In a conference, which the attorney had with the examiner, the question was raised, whether the farming property in each of the estates would qualify for the 2032A special use valuation. No conclusion was reached. The examiner agreed to send the attorney the proposed regulations

as soon as the examiner received them. The examiner in fact furnished the proposed regulations to the attorney on September 8, 1978, which was after the attorney had filed the amended return (on which the 2032A(d)(1) election was made) with regard to The May, 1977 Estate on August 31, 1978, but before he filed the amended return (on which the 2032A(d)(1) election was made) for The April, 1977 Estate on September 14, 1978. The attorney had obtained the proposed 2032A regulations elsewhere before the examiner furnished them to him.

This attorney, who prepared the estate tax returns, is engaged in general practice in a town, the 1970 population of which was approximately 4,600. Although the attorney handles the administration of estates and the preparation of estate tax returns, he does not purport to be a tax specialist.

The proposed regulations, Section 20.2032A-8, which deal with the making of the 1954 I.R.C. Section 2032A(d)(1) election, were published on July 13, 1978. It was provided that they may be relied on, even though not final, to the extent they relate to the procedure for making 2032A, etc. elections, which are "...made before the date which is 30 days after publication of final regulations detailing the procedures for making these elections." Section 20.2032A-8 was partially amended on December 21, 1978 by Section 20.2032A-8(a)(1) and was expanded, also on December 21, 1978, by Section 20.2032A-8(d).

The proposed regulations, Sections 20.2032A-3 and -4(a)-(e), inclusive, which deal with other 2032A matters (i.e., material participation requirements, methods of valuing farm property, determination of gross cash rental, determination of state and local real estate taxes, definition of comparable real property, and definition of effective interest rates) were published on July 19, 1978. On September 10, 1979 Section 20.2032A-4(b), published on July 19, 1978 was withdrawn and a new Section 20.2032A-4(b), proposing a more restrictive method for determining gross cash rentals, was published. The pre-final reliance provision was included only in Section 20.2032A-8, -8(a)(1) and -8(d). It was not included in Sections 20.2032A-3, -4(a), -4(b) (as proposed on July 19, 1978 and as re-proposed on September 10, 1979), -4(c), -4(d) and -4(e); and, therefore, they may not be relied on until they are finally adopted. None of these proposed regulations have been finally adopted; however, when finally adopted, it is proposed that each be effective for estates of decedents dying after December 31, 1976. Thus, representatives of estates, for which the time prescribed for filing estate tax returns (determined without regard to extensions) expired before the publication of the first Section 2032A proposed regulation on July 13, 1978 had no guidance with regard to the election of Code section 2032A special use valuation.

The overall question is whether the section 2032A(d)(1) estate tax special use valuation election for certain farm, etc. real property, if not made on an estate tax return for which the time prescribed for filing (determined without regard to extensions) expired before July 13, 1978 may be made for the first time under that section at a later date within a reasonable time after the section 2032A proposed regulations become final.

We have been unable to find any ruling, etc. on this question; however, representatives of Treasury and the Service have taken the position that the 2032A election may not be made in any way after the due date of the estate tax return (including extensions thereof). In support of their position (1) they cite their alleged longstanding interpretation of the phrase, referred to above, in section 2032A(d)(1) and (2) the interpretation by the courts of what they contend is a similar phrase in Section 2032(c), which pertains to the alternate valuation provision of the Code. They contend that the concluding phrase in section 2032A(d)(1), "...and shall be made in such manner as the Secretary or his delegate shall by regulations prescribe" does not make these cited precedents inapplicable, because they contend that such concluding phrase requires the publication of regulations only as to the "manner" or procedure or method by which the 2032A election itself should be made, that this concluding phrase was not intended

to provide that the election could be postponed until regulations dealing with other 2032A questions than the "manner" in which the election should be made, should be published, and that the requirements of the concluding phrase were satisfied by the provisions made in item 12 of the federal estate tax return Form 706, when it was revised in June, 1977, and in the three paragraphs on the form, which followed the item 12 question: "Is the special valuation authorized in Section 2032A elected for certain farm, etc., real property?..... ______ Yes ______ No." In addition, some Service representatives have made the point that there is no provision in the Code, permitting the filing of amended returns, including estate tax returns, even though they are frequently filed by taxpayers and accepted by the Service. The point made is that an amended return may not be filed and, therefore, that an election made on an amended return is a nullity. Those who have made this point, however, have not dealt with the questions, whether the election may be made by a claim for refund and whether the election made on the amended estate tax return will be treated as a claim for refund of that amount by which the estate taxes previously paid with the original estate tax return will be reduced as a result of the 2032A election.

The above described problem involves not only the estates but also the professional advisers who prepared or advised as to the original estate tax returns on which or with which

the 2032A election was not made at the time the returns were filed, because it raises a very real question of malpractice for the professional advisers.

I have talked with attorneys and accountants in other states than Mississippi, to see if similar problems with regard to the 2032A(d)(1) election are being encountered, and, if so, what the Service has done with regard to them.

One attorney reported that in his state the Service's official position is that in such a situation, a 2032A election is barred on the following ground: (1) Such election was not timely made on the original return, under the expressed terms of 2032A. (2) There is no provision in the Code specifically allowing or authorizing an amended 706. He further stated that unofficially, since there is a very real question of malpractice on the part of an attorney filing a 706 without a proper 2032A election during the interim period prior to the publishing of proposed regulations on July 13, 1978, Service supervisors did not discount the possibility that an examining agent might have, in certain instances, allowed a subsequent 2032A election to be considered as a valid election, or stretched the election procedure to a point where they were interpreting that there had been a valid election, even though the same might be in a cover letter, in order to prevent an attorney from being sued for malpractice, for what they considered to be an obvious error. The attorney, also, related to me that

he has been told by another attorney of a situation in which the latter attorney was permitted to make the 2032A election for the first time, when the audit of the return was begun.

An accountant in a large accounting firm stated that his office is handling a situation with regard to a 2032A election made on an amended return sometime after the original estate tax return had been prepared and filed by the attorney, representing the estate. When the accounting firm saw what had happened, it filed an amended return, on which the 2032A election was made. The accountant stated that that estate tax return had not yet been audited although the decedent died at a time in 1977, which required the estate tax return to be filed before the first proposed 2032A regulations were published on July 13, 1978.

Another attorney stated that he had or knew of quite a number of situations similar to the situation of the two estates we are representing. He particularly mentioned that in several instances he sought information about various aspects of 2032A and what the proposed regulations might or might not contain with regard to his questions and was given information by Service representatives which caused him to believe that the particular estates, for which he had to file estate tax returns before the 2032A proposed regulations were published, would not qualify for the 2032A election, whereupon he did not make the election when the returns were filed; and

that subsequently it developed that under the provisions of the proposed 2032A regulations the estate would qualify.

A preparer of the 2032A proposed regulations has stated that as late as the first of May, 1979 no estate tax return, as to which the 2032A election was made at any time either with the return or at any time after the return was filed, has been closed. He stated that early in 1979 a directive was sent to Service personnel throughout the country, directing them to pull and review all such estate tax returns.

The positions of the Treasury and Service representatives and the information obtained from other attorneys and accountants raise the following questions with regard to the overall question:

(1) Have phrases in other Code provisions, similar to the first phrase in section 2032A(d)(1), been interpreted by Treasury, the Service or the courts over a long period of time to require that the election must be made in all events not later than the time prescribed for filing the return to which the election relates, including any extension thereof?

(2) If it is assumed that the answer to (1) is "Yes," do any of the surrounding circumstances make such interpretation of the first phrase inapplicable to section 2032A(d)(1) or justify some sort of exception from the interpretation with regard to the section 2032A(d)(1) election for estates as to

which estate tax returns must by law be filed (determined without regard to extensions) before the publication of the first section 2032A regulations? Some of the surrounding circumstances which may be considered are:

(a) Unlike other Code provisions, which contain phrases similar to the first phrase, section 2032A(d)(1) contains a second phrase, to-wit: "...and shall be made in such manner as the Secretary or his delegate shall by regulations prescribe..." (italics ours), which may be interpreted to mean that the time for the making of the election, specified in the first phrase, shall be postponed until the first regulations were published. This second phrase, if so interpreted, makes it impossible to comply with the statute in the situation where the time for filing the return expired before the publication of the proposed regulations.

(b) Congress intended section 2032A to be a relief provision for certain classes of estates. There is nothing in the statute or its history to indicate that Congress intended that a harsh, literal interpretation of any part of the statute, particularly the election provisions, should be made. There is no policy or administrative reason, which justifies requiring the election to be made before the publication of the first proposed regulations.

(c) The particular situation, which justifies the making of the election after the return has been filed, can easily be

limited so that it will not occur again. Permission to make the election after the filing of the return could be limited to the situation, where the return must be filed (determined without regard to extensions) before the publication of the first proposed 2032A regulations.

(d) Section 2032A introduced into the estate tax Code an entirely new concept of property valuation. It contains many new and difficult-to-understand provisions, e.g., the estate tax recapture provisions. It involved certain old farming tax principles, which are difficult to understand, such as "material participation." It was adopted simultaneously with two major tax reformations, i.e., (1) of the previously separate gift and estate tax systems into a unified tax system and (2) of the at-death-stepped-up-basis system to the new carryover basis system (recently repealed). There were and are many questions about the situations in which 2032A may be used--e.g., (1) whether it may be used in situations, where the real properties have no higher and better use than farming, etc.; (2) whether it may be used when there are no comparable properties being rented for cash in the vicinity, from which the average rentals factor for the farm valuation formula may be derived. Only recently did the Service answer the first question "yes." Many estate representatives and professionals thought or had been led to believe that the answer was "no,"

that 2032A was not elected and Treasury and the Service contend it is now too late to elect it. It has vacillated on the second as evidenced by its withdrawal on September 10, 1979 of then proposed regulation section 20.2032A-4(b) and proposal on the same date of a new regulation on the same subject. Both before and after its adoption there was (and there still is) much controversy about the desirability of electing 2032A (e.g., the possible adverse effect of the election on the future financing of farm operations), and about its side effects on bases in the event of later tax recapture. In the absence of even proposed regulations in 1977 and the first half of 1978, it was difficult for even experienced tax practitioners to advise with regard to the election of 2032A. The situation resulted in blind advice being required with the real possibility that the making of the election might cause irrevocable damage or problems to the estate and heirs later on and problems for the professional advisers. Failure to make the 2032A regulations final and vacillation by Treasury and the Service on many 2032A questions have caused this uncertainty to become even more burdensome for estates and their representatives and professional advisers. An inherently complicated subject has been made more so by the failure of Treasury and the Service up to now to provide firm guidance which may be relied on.

(e) It is reasonable to assume that a substantial number of estate tax returns are prepared by persons who are not professionals or who were not experienced in tax matters. Certainly, 2032A is even more of a mystery to them. In addition, such persons could be expected (1) to interpret the second phrase of 2032A(d)(1) as providing for the delay of the making of the election until the proposed 2032A regulations become final, and (2) not to recognize the 2032A provisions on Form 706, as revised in June, 1977, as the regulations required by the concluding part of 2032A(d)(1).

(f) The publication of the proposed 2032A regulations was delayed for an extraordinarily long period of time after enactment of Code section 2032A, in view of the facts, that 2032A embodied a new and novel concept in estate tax property valuation and is very complicated. Even the preparers of the proposed regulations have had difficulty in understanding many of its provisions and in resolving many problems with regard to same. IRS personnel have had similar difficulties with it. This has resulted in the dispensation of much information and observations about 2032A provisions which were either inaccurate or which were not later confirmed by or adopted in the proposed regulations. Occasionally, tax practitioners were told that particular provisions of 2032A would be interpreted in certain ways by the then unissued, proposed regulations. This caused the practitioners to advise

that 2032A could not be elected. Subsequently, the interpretation, adopted in the proposed regulations, was such that 2032A could have been elected, but IRS takes the position that the election should have been made on the return and that it is now too late to make it.

(g) A preparer of the proposed 2032A regulations stated early in 1979 that no estate tax return, as to which 2032A was elected, had been closed and that certain IRS personnel were directed to pull and review all such returns. Thus as to such estates, which are not closed before the proposed 2032A regulations become final, the Service will be able to deny 2032A benefits to those estates which do not qualify for same because of the provisions of the final regulations. Conversely, estates of decedents dying after December 31, 1976, for which returns were required to be filed (determined without regard to extensions) before the publication of the first proposed regulations, should be permitted a reasonable time after the regulations become final, to elect initially 2032A where they qualify for same under the final regulations.

(h) In the past with regard to other elections provided by the Code, the Service initially has been lenient as to the time and manner of making them. If it was not going to be lenient with regard to the 2032A election, it should have immediately after December 31, 1976 published something to

that effect and advised that protective elections could be made and that those protective elections could subsequently be revoked, if revocation was desired. Service representatives nevertheless up to July 13, 1978 gave out much information about 2032A, which was confusing and in some cases inaccurate, experienced tax practitioners and Service personnel stated in lectures, etc. that they believed the Service would possibly be lenient in permitting late 2032A elections for a reasonable period of time and the proposed regulations themselves confuse the matter. (E.g., Section 20.2032A-8, the proposed regulations relating to elections allowed under sections 2032A, et al, never state that the election must be made at the time the estate tax return is filed. Instead in section 20.2032A-8(a)(2) the following appears: "Time and manner of making election. An election under this section is exercised by attaching to a timely filed estate tax return, etc." Note the use of the word "is" instead of such words as "shall be," "must be" or "is exercised only." In addition, in section 20.2032A-8(b), containing the provisions as to the "Protective Election," it is provided: "If it is subsequently determined that the estate qualifies for special use valuation or that estate tax is due, an additional notice of election must be filed within 60 days after the date of such determination if the executor desires to use the special use valuation under section 2032A."

Persons other than skilled tax practitioners are apt to read such provisions out of context and to conclude that the proposed regulations thus provide for the filing of a late 2032A election at a time substantially after the original estate tax return has been filed. In the instance of the two estates, represented by our law firm, the Mississippi District Director sent out letters in December, 1978, advising that the 2032A elections previously made in August and September, 1978 should be refiled with the result that the attorney for the two estates spent approximately a week of time and much out-of-pocket money in repreparing and refiling the elections, which the Mississippi District Director's office has now rejected. Possibly the representatives of other estates have been similarly misled.

(i) Elsewhere, as indicated above, Service personnel are reported to have permitted late 2032A elections.

(j) The proposed 2032A regulations take the approach of providing for protective elections, which may be subsequently revoked. The proposed regulations preparers should have assumed, also, that many persons, in doubt about 2032A in the absence of at least proposed regulations, would not think of the possibility of making a protective election which could subsequently be revoked, if desired. On the basis of this assumption, the proposed regulations, should have included, also, a provision for a late election within a reasonable time after the proposed regulations become final.

(k) We have talked to a number of people in the Service and the Treasury about this question of permitting a 2032A election to be made after the estate tax return is filed but within a reasonable time after the proposed regulations become final. Several recognize the harshness of the Service's present position, recognize the malpractice risk to the tax advisers, who prepared the original returns, and express sympathy with the executors of the estates, their heirs and their tax advisers.

(l) The proposed 2032A regulations published on July 13, 1978, same being section 20.2032A-8, were particularly misleading and in the instance of the two estates, represented by our law firm, probably caused the attorney involved to think that the elections could be made even though they had not been made when the original estate tax returns were filed. Subsection (d) reads as follows: "Special rule for estates for which elections under section 2032A are made before September 15, 1978. An election to specially value real property under section 2032A that is made before September 15, 1978 will be treated as a notice of intention to elect under the provisions of this section. For the election to be effective the executor must file an amended notice of election which meets the requirements of this section before January 15, 1979. The amended notice of election is to be attached to an amended estate tax return

and is to be filed with the Internal Revenue Service office where the original estate tax return was filed. If no action to conform the election to the requirements of this section is taken by the executor before the prescribed date, the election will be deemed never to have been made and the payment of any additional tax will be due upon notice and demand." This paragraph was probably misleading, also, to personnel in the Mississippi District Director's office. In the case of the attorney, it probably caused him to file an amended return for one of the estates in August, 1978 and for the other estate on September 14, 1978. In the case of the District Director's personnel, it may have caused them to send in December, 1978 notices to the two estates that the elections made with the amended returns, filed in August and September, 1978, should be refiled. In addition, with regard to the contention of some Service personnel that amended estate tax returns are not permitted and that elections made on or with amended estate tax returns are, therefore, a nullity, note the provision for "an amended estate tax return" in this proposed regulation.

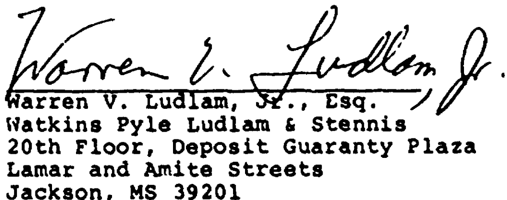
(m) No one outside the government knew in October, 1977 and January, 1978, when the estate tax returns for the two estates we are representing were filed, that the regulations to be proposed would include provisions for "protective elections," which could be revoked, and for "notices of intention to elect."

Certainly neither section 2032A of the Code nor Form 706 (Rev. 6-77) (i.e., the estate tax return form) gave any indication that such would be provided.

Senator Cochran of Mississippi has introduced S. 2946 which would make Section 2032A available to estates which were required to file an estate tax return prior to the issuance of the proposed regulations. S. 2946 would allow estates for which the time prescribed for filing the estate tax return expired before July 13, 1978 to make or revoke the election within 90 days after the later of the date of enactment of S. 2946 or the earliest date on which all necessary Section 2032A regulations became final. The bill also provides for refunds to be made within this 90 day period.

The incorporation of S. 2946 into S. 2967 is necessary to insure that the Congressional intent expressed in Section 2032A is implemented by the Treasury and the Service. Without the provisions of S. 2946, many estates which would have elected Section 2032A if guiding regulations had been available will not be allowed to elect the special use valuation and will be required to sell their farms and small businesses to pay the estate tax.

The American Farm Bureau Federation, the National Cattlemen's Association, and the National Association of Realtors support H.R. 7170, a bill introduced in the House of Representatives by Representative Jamie Whitten which is identical to S. 2946 introduced in the Senate by Senator Thad Cochran, and they likewise support S. 2946 and the suggestion made in this statement that the matter contained in S. 2946 be incorporated into S. 2967.



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MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., August 5, 1980.

Re S. 2805 To amend IRS pronouncements concerning implementation of the U.S. Supreme Court decision in Thor Power Tool Company.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE: The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present its views once again, on a matter of common concern, to the Senate Finance Subcommittee on Taxation and Debt Management. We are interested in several measures before the Subcommittee at this time, and this correspondence deals specifically with Senator Nelson's bill, S. 2805, to provide that Revenue Ruling (Rev. Rel.) 80-60 cannot require a change in a taxpayer's method of accounting for taxable years beginning before 1980.

It will be recalled that the sequence of events leading to S. 2805 essentially began with the U.S. Supreme Court decision of January 16, 1979, in *Thor Power Tool Company* v. *Commissioner of Internal Revenue.* In *Thor*, the Court sustained the Internal Revenue Service (IRS) in disallowing a taxpayer's write-down of "excess goods" inventories to an estimate of market value that had not been substantiated by "objective evidence."

Subsequently, on February 8, 1980, IRS issued Revenue Procedure (Rev. Proc.) 80-5 and Rev. Rul. 80-60. Among other things, these pronouncements purported to require that a taxpayer using a noncomplying accounting method for "excess" inventory—i.e., noncomplying in light of the *Thor* decision—change its method to a permitted one on its first income tax return for its first taxable year ending on or after December 25, 1979. Special consent and transition procedures were set forth for changing to a complying mode spreading the net tax adjustment from the change over a number of years. In addition, IRS stated that this arrangement would not be available to a taxpayer that had used an impermissible method where the method had been challenged on audit and was pending as an issue as of February 8, 1980.

To summarize our position, MAPI takes no exception at this time to the U.S. Supreme Court opinion in Thor as it relates to the inventory issue. As for Rev. Proc. 80-5 and Rev. Rul. 80-60, we are troubled by two provisions, both of which are addressed by S. 2805—one correctly and one, in our judgment, incorrectly. First, we believe that taxpayers affected by the pronouncement in question should be permitted to change their accounting methods for taxable years "beginning after December 31, 1979," and not be required to do so for the first taxable year "ending on or after December 25, 1979." Similarly, the "consent" provision should be made to apply to a taxpayer's first taxable year "beginning after December 31, 1979," and not simply for the first taxable year "ending on or after December 25, 1979." S. 2805 attends to these matters properly.

Secondly, we do not agree with the IRS position of denying the Rev. Proc. 80-5 provisions to taxpayers with pending issues. This seems discriminatory and unwarranted under the circumstances. S. 2805 can be corrected on this score by stating that such taxpayers shall be required to make the change in method of accounting for inventories only for taxable years beginning after January 16, 1979, the date Thor was decided.

If the amendment we have just recommended for S. 2805 were to be adopted, the bill would conform to H.R. 7704 of Congressman Conable, assuming that identical language were to be used. We urge favorable consideration and eventual enactment in this Congress of S. 2805 as conformed to H.R. 7704 so that the inventory issue now settled by Thor can be put to rest on a basis that is fair to all parties. Whereas the IRS decisions on having a consent procedure and gradual transition were appropriate, the provisions involving retroactive application of Thor are abusive and must be changed.

RETROACTIVITY AND 1979

As already noted, we favor Sections (a) and (b) of S. 2805 because they would have the IRS pronouncements apply, for accounting change and IRS consent purposes, to the year or years "beginning after December 31, 1979" rather than "ending on or after December 25, 1979." This would be more nearly equitable for taxpayers because of the timing of the Thor opinion and subsequent events.

More specifically, Thor was decided on January 16, 1979, and it called for procedures that many taxpayers had not theretofore followed in estimating and substantiating market value under the lower-of-cost-or-market rules. Because of the prescribed departures from traditional practices with respect to excess inventory write-

downs and sudden, new, tax liability exposures, many tax advisors told their clients to do nothing pending the publication of further information from IRS. Indeed, it was common knowledge among such advisors that the Service was developing a revenue procedure and revenue ruling to implement Thor, including a blanket consent to changes in method of accounting and rules for a 10-year "spread" in many cases for the net adjustment under Code Section 481(a).

For many firms, including calendar-year companies, Thor was decided after their accounting periods had begun. Although the opinion was handed down on January 16, 1979, detailed information on its content and implications was not available for a period of time following the decision. In some situations, taxpayers may not have even heard of the case before IRS made its announcements more than a year later. We hardly need observe that substantial changes in inventory accounting procedures are not undertaken until the consequences of a happening such as this are known.

Obviously, too, IRS has a hand in informing taxpayers of their new obligations and exactly what was needed to be in compliance. The responses to conform to new case law are not instantaneous, particularly when the new law entails practices not previously or uniformly followed. For its part, IRS took until February 8, 1980 to produce Rev. Proc. 80-5 and Rev. Rul. 80-60 notwithstanding the high priority and numerous personnel assigned to the project. We should note further that these two documents were not published in the Internal Revenue Bulletin (IRB) until March 10, 1980.

Then, because of ambiguities in the original IRS instructions that caused substantial taxpayer confusion, the Service had to issue Announcement 80-54 on April 8, 1980 to amend and clarify Rev. Proc. 80-5. By the time this date was published in the IRB, along with amended Rev. Proc. 80-5, the date was April 28, 1980.

Under these conditions, IRS should not have reached back to 1979. In fact, various independent professional counselors to IRS during the course of formulating Rev. Proc. 80-5 and Rev. Rul. 80-60 advised the Service not to do such a thing. It seems to us that, when the general advice given to taxpayers is to await information from IRS, then the Service should not, through its own delay, leave taxpayers unable to comply to avoid additional liability for a preceding, closed fiscal year.

This is not fair dealing on the part of the tax collector, and we urge the Subcommittee to have the implementation of Thor be prospective in the manner recommended.

RETROACTIVITY AND PENDING ISSUES

As to situations where issues are pending, we do not know why IRS chose to carve them out for separate treatment. In view of the decision to "bury the hatchet" on past years generally for this dispute, IRS must have decided that inventory accounting methods varied so considerably for write-downs of merchandise that a "clean slate" was in order for compliance under Thor. Since, Thor, it has become apparent that "excess goods" and "percentage" write-downs were rather commonplace, and that the persons using them did so without any understanding that the practices were impermissible. In fact, such write-downs passed muster with many independent accountants, tax counsel, other practitioners, and IRS auditors, and were treated for "book" purposes as generally accepted accounting.

It seems discriminatory to us to have taxpayers with pending issues be singled out for exclusion from the special transitional arrangement when many other parties are forgiven under practically identical circumstances simply because an auditor did not choose to quarrel with their inventory accounting. We would add that the percentage write-downs of persons with pending issues normally have involved honest differences of opinion, as occurred in Thor, and that questions to which the answers are "clear" simply do not make their way to the U.S. Supreme Court for resolution.

All objective observers would have to agree that IRS has won a major case in Thor. Affected taxpayers are changing to more restrictive inventory accounting, and may have higher tax liabilities in some instances as a result. A relatively lenient transition has been provided, and we hear little discussion of Thor now that one and one-half years have passed. If the retroactive aspects of the IRS pronouncements could be put aside, we believe that the irritations and animosities associated with this entire episode would abate, and that the necessary changes would be made in a quiet and orderly way.

In our view, those parties who respectfully dissented and acted in good faith should not be penalized now through assessments of interest and by excluding them from favorable transitional privileges. Accordingly, we urge the Subcommittee to amend S. 2805 as we have recommended.

This concludes our remarks on S. 2805, and we again thank the Subcommittee for its attention and courtesies.

Respectfully,

CHARLES W. STEWART, *President.*

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., August 6, 1980.

Re S. 2775 Concerning the treatment of retirement and similar plans maintained for nonresident aliens.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE: The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present its views to the Senate Finance Subcommittee on Taxation and Debt Management concerning S. 2775 introduced by Senator Bentsen and his co-sponsors, Messrs. Talmadge, Moynihan, Baucus, Dole, Chafee, and Wallop.

As the Subcommittee is aware, S. 2775 is intended to modify the tax law concerning contributions made by U.S. companies or their subsidiaries with respect to retirement and similar plans maintained abroad primarily for nonresident aliens. Senator Bentsen noted, upon introduction of his bill, that the Employee Retirement Income Security Act (ERISA) was enacted in 1974 to prevent pension abuses and to ensure that retirees received their earned pension benefits. Whereas foreign plans were specifically exempted from the labor law portions of ERISA in Title I and the termination insurance provisions of Title IV, Title II containing the tax portions of ERISA was "silent" on this point, perhaps by inadvertence. The legislative history does not shed light on the omission.

Because ERISA does not expressly exempt foreign plans in Title II, the Internal Revenue Service (IRS) has taken the position that deductions under plans that are not "qualified" under Code Section 401(a) generally are permissible only when the employee becomes vested in a funded amount in a separate account, a limitation set forth in Section 404(a)(5).[1]

In the case of plans maintained by a controlled foreign corporation (CFC), IRS contends that a reduction of the CFC's earnings and profits (E&P) pursuant to Section 964 in figuring the parent's deemed-paid U.S.-based company with the same plan would be entitled to a deduction. Under the circumstances described in a related IRS pronouncement, this meant that E&P could be decreased only by the amount of payments actually made under the CFC's pension plan, and not by the liabilities accrued even though local law allowed a deduction for the full accrual.[2]

As recognized by Senator Bentsen and his cosponsors, retirement and other such plans are normally regulated by the countries in which those plans are operative. Moreover, U.S. businesses and their CFCs should not be denied legitimate deductions merely because the rules for plans in a foreign country differ from the standards specified in ERISA. We might add that IRS's belated interpretations have been a most unwelcome surprise to many U.S.-based taxpayers with foreign branches and CFCs that maintain plans abroad for nonresident aliens fully in accord with applicable foreign laws. To our knowledge, the only purpose of affected taxpayers has been to comply, and there never has been any plausible reason for them to assume, for example, that a CFC was to maintain its retirement plan for local personnel in accordance with ERISA in order to preserve the usual tax attributes.

Without intending to digress or to overstate the matter, we think it is about time for the U.S. federal government to cease imposing its will and U.S. societal values on foreign offices and entities through "long arm" statutes; the use of U.S. control persons and entities with CFCs as "conduits" for this purpose; and sweeping, extraterritorial edicts by administrative bodies such as IRS.

Accordingly, we endorse the principle of S. 2775, and urge favorable consideration by the Subcommittee. The bill would achieve an equitable result in most situations, striking a balance between what has been the reasonable understanding of taxpayers since enactment of ERISA and the concerns IRS may have for any potential revenue loss. As to the last-mentioned consideration, we believe that the bill goes more than half-way toward an accommodation with the Service because Titles I and IV of ERISA exempt foreign plans, and the failure to state otherwise in Title II—

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[1] See private IRS ruling LTR 7904042. There are some exceptions to the general prohibition.
[2] See National Office (IRS) Technical Advice Memorandum LTR 7839005 of June 21, 1978.

assuming for the sake or argument that coverage was intended—could only have served to mislead. In our opinion, any "exposure" of the revenues would be minimal, and the limited "carve out" for foreign plans in Senator Bentsen's bill is not only precedented in the foreign tax credit (FTC) area, but would place the imprimatur of Congress on a practice that was considered by taxpayers to be authorized in any event.

Along the same lines, we believe that an effective date should be included in S. 2775 and should correspond to that of ERISA for foreign branches; be indefinitely retroactive for foreign subsidiaries' E&P determinations; and be contemporaneous with the effective date of Code Section 679 for foreign situs trusts of U.S. grantors where U.S. beneficiaries are involved.

The remainder of this letter is in amplification of the preceding remarks. Aside from the honest disagreement that apparently exists regarding Title II of ERISA, already mentioned, we feel that there are useful purposes to be served by S. 2775 in terms of (1) disengaging ERISA from application to foreign plans; (2) the evolution of the FTC provision; (3) keeping tax accounting more in line with generally accepted accounting principles (GAAP); and (4) preventing tax distortions that otherwise could arise from E&P computations.

DISENGAGING ERISA

The IRS interpretations noted earlier seem to be predicated on the highly irregular view that Congress intended ERISA to apply to foreign plans sponsored by a domestic person or CFC, even where no U.S. beneficiaries (or few) are involved. We do not believe this to have been the case for foreign subsidiaries because they are incorporated under and their plans are subject to foreign law. Regarding foreign branches, U.S.-incorporated firms are involved but their plans are subject to foreign law, and we can only attribute the ERISA connection to an omission on the part of the Act's drafters to cover the subject. What S. 2775 would accomplish today should have been covered in 1974, and we do not see merit in extending U.S. concepts of private retirement systems to social milieus where they are improper, irrelevant, conflicting, and/or unadministrable.

To elaborate, foreign laws pertaining to private pension and similar plans vary considerably from the U.S. approach in ERISA, and we are concerned that IRS would require—in effect—that these plans conform to two different statutes. There is simply no sense in having a U.S. law operate as a constraint on a foreign plan subject to local laws that are a product of a different political and socio-economic system. Additionally, to require this would be to require very costly amendments to plans that already have been approved by foreign jurisdictions. Non-U.S. competitors of U.S. companies and CFCs would have a distinct competitive advantage because of the additional administrative and/or compensation cost associated with compliance for the hapless U.S. branches or CFCs saddled with plan regulations promulgated in two different countries.

As noted earlier, we do not concur in the exportation of U.S. "values" haphazardly and in violation of local custom or protocol. The position of IRS that would be corrected by S. 2775 strikes us as not only haphazard, but without the least consideration for political or commercial implications.

FTC EVOLUTION

We believe that there is a parallel between the IRS position in the foreign plan context and its awkward posture taken in regard to the creditability of foreign taxes generally.

Contemporaneously, the Service and its overseers at Treasury are developing regulations to confine credibility to a narrow range of foreign income taxes paid or accrued, in keeping with what has become known as the "mirror image" theory. Proponents of this concept consist in the main of IRS, some economic isolationists, and certain collective bargaining agents who believe that the double taxation of foreign operations of U.S.-based companies will result in more investment and employment stateside. We will not dignify the "mirror image" concept or its disciples further herein beyond noting that there is grave concern among taxpayers about the pending IRS proposals, along with considerable planning for the contingency of promulgation.

The parallel we see is that IRS' position of foreign plans can operate to prevent a full indirect FTC from being available to the U.S. parent of a CFC. To this extent, we find that IRS is, in effect, reading Code Section 902 in such a way as to require that foreign income tax systems be virtually identical to the U.S. income tax in order to have the foreign levies be treated as creditable under Section 901. We are aware of the influence of Sections 964 and 446 on IRS, but it seems to us that,

within the ambit of administrative discretion, IRS could administer the FTC more fully in conformity with congressional intent. The credit does indeed have constraints and limitations, but the overriding purpose was to avoid economic paralysis through double taxation. If the Service will not comply with its mandate, Congress should intervene.

Inasmuch as we have seen few signs of administrative awakening by IRS in respect of the "foreign plans" question and some signals from IRS are to the contrary—even for E&P determinations where IRS has considerable latitude—S. 2775 seems in order for active consideration and enactment.

GAAP

Paradoxically, IRS vacillation in regard to GAAP is one of the constants of federal income tax administration. In one Administration the "message" is that tax accounting and book accounting should conform to the extent practicable. In another, the "word" is that conformity, as a general principle, is a snare and a delusion. In the *Thor Power Tool Company* decision—dealt with in another letter of MAPI to this Subcommittee concerning S. 2805—the U.S. Supreme Court addressed this somewhat arcane subject. The revelations contained in Thor about the supposedly "vastly different objectives that financial and tax accounting have" are extreme and unenlightened, whatever else may be said for or against the opinion.

GAAP comes to mind in the foreign pension context because it is another area where IRS chooses to depart from normal accounting conventions. More specifically, the IRS position in this context places it in opposition to what are normal accruals under GAAP, yet IRS customarily is a champion of accrual accounting—at least for taxpayers with inventory. In our opinion, tax accounting should conform to book accounting wherever practicable, and there should be no argument about deductions for foreign plans that are consistent with GAAP. We readily acknowledge that there will be exceptions to accounting principles in the tax context, but they should be relatively few in number and—and our opinion—need not have arisen here. S. 2775 can restore the situation to order, and GAAP is another reason to do so.

EXCEPTIONS

At least one taxpayer has contended that, at the level of a foreign subsidiary, an inability to adjust E&P for a full accrual may result in the full amount of foreign taxes paid by a CFC not being deemed paid by the parent due to the unavailability of funds for dividend distribution to the parent. This may lower and distort the true effective rate of tax of the subsidiary. When this argument was made to IRS in a request for technical advice, the Service observed in response that one could also have distortion where actual pension payments exceed accruals. Notwithstanding, IRS went on to state that Congress may provide a statutory exception when faced with a distortion due to an E&P determination, as has been done for blocked currency under Section 964(b) for purposes of "subpart F." Although Congress may not have done such a thing for foreign pension plan accruals to date, we certainly do not consider this failure to act as having any negative implications for this purpose.

It would appear that S. 2775 can provide the kind of "carve out" that has been authorized by statute elsewhere and end further bickering about congressional intent as to foreign plans. We commend such action.

EFFECTIVE DATE

We repeat that S. 2775 should not be left without an effective date or there will be confusion and disputes between taxpayers and IRS. Also, if Congress is going to settle the question of ERISA and foreign plans, it should do so thoroughly and unequivocally rather than leave "loose ends" that promote further discord. If the decision implicit in S. 2275 is correct for any purpose, it should be correct for all of them. Accordingly, the effective date as it pertains to foreign branches should be made concurrent with the effective date of ERISA. For E&P computations, the new law should be indefinitely retroactive because the mechanics of computing E&P require such retroactivity if the purpose of the law is to be achieved. We suggest that the amendments to the foreign situs trust provisions apply from the date of enactment of the trusts sections.

CONCLUDING COMMENT

At various points in this letter, we have referred to the erroneous IRS pronouncements that have led to the introduction of S. 2775. In concluding, we acknowledge that Treasury has expressed support for the bill in most of its features, and even

had a significant role in its preparation. Although Treasury will not allow plan deductions to be taken with specific reference to amounts allowable under foreign income tax systems, it supports the remedy because the extension of ERISA to foreign plans is not appropriate and S. 2775 would establish various circumstantial assurances of appropriateness of the amounts in question. However, while the policy discussions continue in Congress with apparent Treasury acquiescence, revenue agents are still pressing this issue in the field. We mention this because it suggests that existing Treasury administrators either agree with the IRS reading of current law or choose not to intervene to urge restraint on IRS despite its questionable posture.

Under these circumstances, we urge prompt action by the Subcommittee on S. 2775, including appropriate additions to the bill to assure that it will be retroactive as well as prospective in application.

MAPI, again thanks the Subcommittee for its consideration of the Institute's views regarding S. 2775.

Respectfully,

CHARLES W. STEWART, *President.*

MCCLURE & TROTTER,
Washington, D.C., August 28, 1980.

Re S. 2775.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: These comments in support of S. 2775 are submitted on behalf of the Coca-Cola Company. Generally, S. 2775 would clarify and codify existing law relating to the U.S. tax treatment of nonqualified pension plans maintained by foreign subsidiaries of U.S. corporations and U.S. corporations operating abroad through branches.

By way of introduction, it is important to note that the statutory rules in the Internal Revenue Code have reflected, at least since 1942, considerations beyond accurately determining the current income of an employer maintaining a plan of deferred compensation. In most instances, when an expense is incurred by a taxpayer in its business, the other party to the transaction has a corresponding amount of income, and the aggregate U.S. tax base is not reduced. For example, if a taxpayer pays or accrues wages, rent, or interest, the recipient will be subject to tax on these amounts, typically in the same taxable year. Because virtually all employees use the cash method of accounting, this matching of expense by the employer and income to the employee may not occur with respect to deferred compensation, and Federal revenues may be significantly reduced.

The long-standing policy of the United States has been that such revenue reductions are appropriate only in the case of deferred compensation plans which meet certain minimum standards. These standards reflect a social policy of benefitting and protecting American workers. Originally, these standards were basically the nondiscrimination requirement and the funding requirement (i.e., that the amounts set aside be placed in trust to protect the employees). In 1974, the Congress added a number of additional requirements (e.g., minimum vesting and participation standards, joint and survivor annuity requirements, and benefit commencement requirements).

If these standards are satisfied, the employer is allowed a current deduction but the employee is not subject to tax until benefits are received. If these standards are not satisfied, generally both the allowance of the employer's deduction and the employee's receipt of income will occur in the same year. As a general matter, if the plan is funded, these events will occur when the employee's rights become vested; if the plan is not funded, these events will occur when benefits are paid to the employee. An exception to the foregoing involves funded plans under which a separate account is not maintained for each employee; in such a case, the employer is never allowed a deduction. By contrast, under generally applicable tax principles, an accrual method employer's deduction would be allowable for the year in which the services are performed (i.e., the year in which the benefits are earned).

The foregoing analysis demonstrates that the existing statutory rules for deducting deferred compensation costs do not purport to match income and expense from the standpoint of the employer. Rather, these rules are exceptions to this generally applicable principle. These rules are premised on the assumption that both the employer and, more especially, the employee are U.S. taxpayers, and can be justified where this is the case. Where this is not the case, the social policy and anti-tax

avoidance factors underlying these rules are irrelevant, and there is no reason to depart from the generally applicable principle and allow the employer to deduct the deferred compensation earned currently by its employees.

The extent to which the foregoing considerations are reflected in existing law is uncertain. The Internal Revenue Service has issued one private letter ruling (involving foreign branches of U.S. corporations) and one technical advice memorandum (involving foreign subsidiaries of U.S. corporations) in which it refused to give any effect to these considerations in applying the relevant provisions of the Code. Rather, the Service has taken the position that the employer is never allowed a deduction for contributions to a nonqualified funded plan under which a separate account is not maintained for each employee and that the expense of an unfunded plan may be taken into account only when benefits are paid rather than when earned. Moreover, if this statutory language is read literally, no deduction is ever allowable for the cost of nonqualified pension plans for nonresident aliens employed outside the United States. (This follows from the fact that section 404(a)(5) of the Code allows the employer a deduction only when the deferred compensation is includible in the gross income of the employee, and sections 862(a)(3) and 872(a)(1) provide that compensation for personal services performed abroad is income from sources without the United States and is not includible in the gross income of a nonresident alien. Thus, since nothing is ever includible in the gross income, nothing is deductible by the employer.) Even the Income Tax Regulations of the Treasury Department do not construe section 404(a)(5) this strictly to deny deductions in all cases, but have not dealt with all of the problems in this area adequately, as demonstrated by the positions taken by the Service.

The confused attitude of the Service toward foreign pension plans is further underscored by a very recent technical advice memorandum holding that, unlike a domestic situs pension trust, a foreign situs pension trust cannot be exempt from Federal income tax. The rationale for this conclusion is that the beneficiaries of this trust are primarily nonresident aliens and that therefore the trust does not satisfy the requirement for such exemption that it be "similarly circumstanced [to domestic pension funds benefitting American workers]." As the Service pointed out, "the social purposes served by domestic pension plans (to benefit American workers) would not apply to a foreign pension fund benefitting primarily foreign workers."

Thus, there is considerable uncertainty as to the extent to which existing statutory law is subject to considerations of U.S. social policy when the statutory rules are applied to foreign pension plans. Clearly, the Service has denied tax benefits to a foreign pension plan that would have been allowed had it been a domestic pension plan solely because there was no U.S. social policy in allowing such benefits because the foreign pension plan benefitted "primarily foreign workers." Since the United States has no interest in "a foreign pension fund benefitting primarily foreign workers," there is no reason to deny an employer maintaining such a plan a deduction for the deferred compensation currently earned by these employees.

S. 2775 would end the existing confusion in this area by providing specific and comprehensive rules under which both foreign subsidiaries and foreign branches of U.S. corporations are to take account of the expense of pension plans maintained primarily for the benefit of persons substantially all of whom are nonresident aliens. This bill would provide specific rules for determining the amount of pension expense attributable to the current taxable year, thus resulting in a reasonable measure of the employer's actual income for that year.

In its testimony before the Subcommittee on S. 2775, the Treasury Department supported the principles underlying S. 2775, primarily for the reasons set forth above, but stated that this legislation should apply prospectively only insofar as it applies to foreign branches of U.S. corporations. It is indeed anomalous for the Treasury Department to support legislation on the ground that it is reasonable and sound and at the same time to take the position that a different rule—presumably one that is not reasonable and sound—should apply for the past.

As noted above, if the provisions of the Internal Revenue Code relating to deducting the cost of nonqualified pension plans maintained for nonresident aliens are read strictly, no deduction is ever allowable to the employer. Thus, it seems clear that when section 404(a)(5) was last amended in 1969, an unintended oversight occurred, and S. 2775 should be regarded as correcting this oversight. Thus, it would be entirely appropriate for this legislation to be made retroactive to 1969 (the effective date of present section 404(a)(5)). In this regard, it is important to note that the Treasury Department supports a retroactive effective date for the amendment which S. 2775 would make to section 679 on the ground that the scope of that section as originally enacted and now exists was also too broad.

Another consideration supporting retroactivity is the fact that a major, but not the exclusive, reason why the funded pension plans of foreign branches of U.S.

corporations are not qualified are the additional requirements for qualification imposed by the Employee Retirement Income Security Act of 1974. While making the provisions of S. 2775 as they relate to these plans retroactive to the effective date of these additional requirements would not be a complete solution, it would as a practical matter be reasonably adequate.

In summary, S. 2775 is a soundly conceived bill and, with the effective date change noted above, should be promptly enacted.

Sincerely yours,

WILLIAM P. MCCLURE, *Attorney.*

WILLIAM M. MERCER INC.,
New York, N.Y., August 8, 1980.

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

DEAR MR. STERN: This letter is to affirm our strong support for S. 2775.

William M. Mercer, Incorporated is the nation's largest employee benefit plan consulting firm. Included among our clients are several hundred companies which maintain directly or through subsidiaries retirement benefit programs on behalf of employees who are employed in countries throughout the world. The number of such plans run into the thousands.

We are extremely concerned over the rigid, literal construction by the Internal Revenue Service of present Section 404(a)(4) of the Internal Revenue Code. Enforcement of this construction would undermine the tax relief previously available under Code Section 404(a)(4) on account of contributions paid or accrued under such retirement benefit plans for foreign employees. Tax relief would be available only if such foreign plan reflected the provisions of the Employee Retirement Income Security Act (ERISA). As a practical matter this would entail the exporting of U.S. retirement plan standards and practices. In some countries, this requirement would be contrary to local law so that the effort to accomplish U.S. tax relief would mean the loss of local tax relief, thereby defeating the point of the exercise.

In other countries, the design and practices involved in plans for U.S. employees are neither practical nor desired, and in some instances make no sense whatever.

Adoption of S. 2775, by restoring the assurance of tax relief which prevailed for so many years before ERISA, may fairly be categorized as a triumph for common sense. In our view, it reenacts the original intent of Congress to extend tax relief for amounts paid or accrued for foreign-based retirement plans.

Sincerely,

LLOYD S. KAYE, *Vice President.*

PRICE WATERHOUSE & CO.,
Washington, D.C., August 6, 1980.

Hon. HARRY F. BYRD, Jr.,
Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, Washington, D.C.

DEAR SENATOR BYRD: We are pleased to have the opportunity to express our support for passage of S. 2805, introduced by Senator Gaylord Nelson. This bill would delay the effective date for application of Rev. Proc. 80-5 for one year. Unless this proposed legislation is enacted, Rev. Proc. 80-5 will require taxpayers presently using methods of valuing excess inventory, which do not strictly comply with current income tax regulations, to change to a method of evaluation consistent with the Supreme Court's decision in *Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522 (1979). In the absence of legislation, this requirement will be mandatory for the taxpayer's first taxable year ending after December 25, 1979 (e.g., retroactive to calendar year 1979).

We understand our support for Senator Nelson's bill and the companion bill introduced in the House by Congressman Barber Conable (H.R. 7390) is consistent with the position of the Federal Tax Division of the American Institute of Certified Public Accountants (AICPA). We are aware that the AICPA, other taxpayer representatives, and particular taxpayers, have set forth a number of reasons for postponing the effective date of the Revenue Procedure. We would like to add two additional thoughts.

First, we believe that the one year grace period provided by S. 2805, for compliance with the regulations for valuation of excess inventory, will give taxpayers necessary time to appropriately evaluate the adoption of the LIFO (last-in, first-out)

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method for valuation of inventory. The additional time would also allow taxpayers to avail themselves of alternative courses of action including disposition of "excess" inventory, in order to eliminate an unforeseen drain on cash for taxes owed because of Rev. Proc. 80-5. These considerations are particularly important to small business where the LIFO method of valuing inventories is not utilized all too often, and cash needs are frequently critical.

Second, a one year delay would permit the Internal Revenue Service to issue clear rules which would enable taxpayers to distinguish between excess inventory and that which is obsolete or defective, thereby assisting taxpayers facing the dilemma presented by the Thor decision. This distinction is important as the Thor decision allowed a write down for inventory which is obsolete or defective and did not allow a write down for excess inventory.

For at least four years, the public has been aware of a regulation-project which would revise the "cost or market whichever is lower" rules of the regulations covering Section 471 of the Internal Revenue Code. The July 18, 1980 status report indicates a June 1, 1977 final draft of the notice regarding this matter, was sent to the Tax Legislative Counsel of the Treasury Department. This project, which has not been designated high priority, should be expedited in view of the Thor decision and taxpayer concern with applicability of Revenue Procedure 80-5. Presumably one year would allow ample time to promulgate these regulations.

In summary, it is our feeling that adoption of S. 2805 would increase total observance of the Thor decision by allowing taxpayers sufficient time to plan for orderly compliance with the regulations and Rev. Proc. 80-5. While many taxpayers have found it possible to comply with the Revenue Procedure, there are some, including many small businessmen, who will be unable to adequately address the problem prior to filing tax returns for years ending after December 25, 1979. Here it is important to note the time frame for taxpayer consideration of this problem was quite short because Rev. Proc. 80-5 was not published until March 10, 1980, which was over one year after the Supreme Court decision.

With all these factors considered, it would appear that a one year extension of time for compliance is not only justified, but necessary in this case.

Yours very truly,

PETER J. HART,
National Director of Tax Policy.

PRICE WATERHOUSE & CO.,
Washington, D.C., August 28, 1980.

Hon. HARRY F. BYRD, Jr.,
Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, Washington, D.C.

DEAR SENATOR BYRD: We are pleased to have the opportunity to express our support for passage of S. 2775, introduced by Senator Bentsen, which was considered by your subcommittee at public hearings on August 4, 1980. The bill proposes to amend the Internal Revenue Code as it applies to nonqualified deferred compensation plans for nonresident aliens. It is designed to remedy certain problems which, in part, accrue to U.S. taxpayers as a result of an apparent oversight of the Employee Retirement Income Security Act of 1974 (ERISA).

THE BILL

The bill would provide special rules regarding allowance of U.S. tax deductions for nonqualified (under U.S. law) deferred compensation plans maintained for the primary benefit of nonresident aliens. It would also provide special rules for determination of earnings and profits of certain foreign companies having nonqualified deferred compensation plans, and special rules for foreign trusts created by U.S. grantors which do not explicitly prohibit benefit payments to U.S. taxpayers.

The first two provisions of the bill would permit both foreign branch operations of U.S. companies, and certain foreign companies, to use rules which would approximate accrual basis rules for nonqualified deferred compensation plans. These rules would cover plans where substantially all of the participants are nonresident aliens. The net result would be to allow taxable income in the case of branches, and earnings and profits in the case of subsidiaries, to be reduced by taking into consideration a company's obligation to a deferred compensation agreement by reference to the accrual method of tax accounting, provided the obligation is fixed and determinable without regard to whether a separate fund is established.

The bill provides that four requirements must be met in order to secure an accrual basis deduction. These rules follow:

1. The benefits provided by the plan must be either required by foreign law or set forth in a written document communicated to the active participants;

2. For defined benefit plans, the deduction is limited to amounts paid or accrued in respect of benefits that are reasonably capable of actuarial estimation;

3. The actuarial cost method and assumptions used must, in the aggregate, be reasonable to the extent the amount taken into account is dependent upon actuarial determinations; and

4. The amount to be taken into account for a taxable year must be determined in a manner consistent with generally accepted United States accounting principles applicable to the charging of pension costs against income.

These and other specific rules included in the bill will assure enactment would not result in taxpayer abuse.

BACKGROUND AND NECESSITY FOR LEGISLATION

Many U.S. companies which do business outside of the United States maintain deferred compensation plans for the benefit of nonresident aliens working in foreign locations. In many instances, deferred compensation plans covering foreign employees are entered into voluntarily and in other circumstances the deferred compensation arrangements are prescribed by foreign law. It is typical for U.S. companies operating outside of the United States to carry on business either through foreign subsidiaries or branch offices of United States' companies. Typically a substantial portion of the participants in the foreign deferred compensation plans are nonresident aliens.

Many of the foreign country's rules, applying to the deferred compensation plans in question, differ markedly from the rules applied to similar plans in the United States. Consequently, the operative rules, including those involving tax law, which apply to foreign and domestic deferred compensation plans differ significantly, without regard to benefits or coverage. For example, a common trait of a U.S. pension or similar benefit plan is funding through a trust vehicle. Such funding is not typical in many foreign jurisdictions. To the contrary, current funding of deferred compensation arrangements through a trust medium is discouraged in some countries. In certain instances current funding through a trust has a detrimental effect on the foreign employee. It is clear that payments under deferred compensation agreements, whether applying to domestic or foreign situations, are ordinary and necessary in the business context.

The enactment of ERISA in 1974 substantially changed the rules regarding the operations of deferred compensation plans, including U.S. tax deductibility of payments made under such plans. Provisions of this Act differ significantly from those of most foreign countries. Practice has shown it to be difficult, if not impossible, for most U.S. employers to conform deferred compensation plans covering nonresident alien employees of either a branch or foreign subsidiary to requirements of ERISA and the rules of the host foreign country.

The Internal Revenue Service has recently made it clear in a private letter ruling and a technical advice memorandum, that a company's foreign deferred compensation plans must conform to U.S. rules in order to secure desired U.S. tax benefits. While the position of the Internal Revenue Service may be well founded by reference to the rules under ERISA, dual compliance is impossible in many situations.

The private letter ruling concerned the deductibility by U.S. corporations having a foreign branch. In this ruling it was held that contributions to a pension trust were not deductible for U.S. income tax purposes, at either the time that they were paid to the trust or at the time the benefits were actually paid to the employees. The technical advice memorandum concerned determinations of a foreign subsidiary's earnings and profits. Here the IRS concluded that foreign subsidiaries cannot take accrued pension plan liabilities into consideration in determining earnings and profits for U.S. tax purposes.

There is some evidence that these rulings indicate an unintended result of the 1974 legislation. The provisions of S. 2775 would assure that these unintended results do not continue.

EFFECTIVE DATES

S. 2775 does not specify effective dates for various of its provisions, which for certain of these provisions are important.

It appears that the question regarding U.S. income tax deductibility of payments made under deferred compensation arrangements covering nonresident alien employees of a foreign branch of a U.S. company, was highlighted by enactment of ERISA. It therefore seems appropriate to relate the effective date of this provision to the date of ERISA's enactment.

It is less clear that the question regarding the impact of payments made under nonqualified deferred compensation arrangements of foreign subsidiaries traces back to the enactment of ERISA. With this in mind, an effective date applied to all past years of a foreign subsidiary would seem appropriate with a view toward avoiding prolonged litigation.

SUMMARY

Enactment of S. 2775 would be a positive step toward resolving what appears to be an unintended U.S. tax result arising from ERISA, which was enacted with a primary view toward controlling admininistration and operation of deferred compensation plans as they apply to U.S. taxpayers and their U.S. employees. Further, enactment would relieve both the private sector and the public sector from the extreme burden of determining whether foreign deferred compensation plans qualify under ERISA and the applicable rules of the foreign host country. Finally, enactment would enable the U.S. business community to plan appropriately for the continued use of foreign deferred compensation plans.

Yours very truly,

PETER J. HART,
National Director of Tax Policy.

R. J. REYNOLDS INDUSTRIES, INC.,
Winston-Salem, N.C., August 15, 1980.

Re S. 2775—To amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

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

DEAR MR. STERN: This written statement is in lieu of personal appearance at the public hearing before your committee that occurred on August 4, 1980. R. J. Reynolds Industries supports the enactment of S. 2775.

R. J. Reynolds is engaged through subsidiaries and branches in the domestic and international manufacture and sale of tobacco products, foods, and beverages, transportation, energy and packaging products. As of December 31, 1979 R. J. Reynolds Industries had approximately 79,500 regular employees. Principal subsidiaries are located in Canada, the United Kingdom, Germany, the Netherlands, Puerto Rico, West Germany, the Philippines, Panama, Costa Rica, Guatemala, Liberia, Mexico, Kenya, and Bermuda with minor subsidiaries in numerous other countries. Branches of Sea-Land Service, Inc., our shipping subsidiary, are located in more than 50 foreign countries.

RJR employs a substantial number of non-resident aliens at our numerous foreign locations. A large number of these employees are included in foreign pension plans. Because of the uncertainty in the law, we are faced with the possibility of incurring substantial non-deductible costs in order to maintain these plans.

Meeting the requirements of both U.S. and foreign law is a complex, difficult task that frequently results in plans that are inconsistent with customary foreign local practices. The circumstances produced by inconsistent U.S. and foreign law has in some cases increased our benefit costs, placing us at a competitive disadvantage.

We believe that no justifiable social purpose is served by extending to nonresident aliens the protections contained in ERISA which were designed for U.S. employees. Congress appeared to concur in this judgment in 1974 when it excluded plans maintained primarily for the benefit of nonresident aliens from Title I and IV of ERISA.

We therefore strongly endorse the subject bill and urge your subcommittee to report out this bill favorably at the earliest possible date.

Very truly yours,

M. J. MURPHY,
Director-International Taxation.

ROSS, LANDIS & PAUW,
Riverside, Calif., August 19, 1980.

Re Revocable living trusts and benefits under section 6166A and section 2032 of Internal Revenue Code.

Hon. S. I. HAYAKAWA,
Senate Office Building,
Washington, D.C.

DEAR SENATOR HAYAKAWA: During the past several years, as you may be aware, there has been a very strong reaction on the part of the public against the probate system. This reaction has existed throughout the country and has been especially prominent in California.

The dissatisfaction with probate has been due to a number of factors and especially the following:

(1) The considerable cost of probate, including attorney's fees.

(2) The onerous requirements and complexity of probate. Statutory law in many of the states, and also California, has required the fulfillment of many legal technicalities that often seemed to serve no business, governmental, or social purpose.

(3) The extended time often involved in settling probate estates and making final distribution to heirs and beneficiaries.

(4) The fact that the probate of an estate is a public matter and entails publicity concerning a decedent's business and personal affairs.

As a means of avoiding probate and forestalling what was perceived as the many disadvantages of probate, a very widespread movement has developed relating to the establishment of revocable, living trusts. It is very common nowadays for a husband and wife (or other individual) to transfer all their assets to a trust pursuant to the terms of a trust agreement which provides for the disposition of their estate in the same manner as might normally be done by a Will. The trust, if properly set up and implemented, will avoid probate, although it will not achieve savings of death taxes beyond those also available if there is a Will and a subsequent probate.

I wish to call to your attention two provisions in the Internal Revenue Code, which I believe are of very great importance, that appear at this time to cause problems for revocable, living trusts and discriminate in favor of probate estates. They are the following provisions.

(1) Section 6166A which grants an election for payment of Federal Estate Tax over 10 years where a decedent's estate consists of closely held business interests and is essentially non-liquid. However, this section states that the payment of the tax will be accelerated if 50 percent or more in value of an interest in a closely held business is distributed, sold, exchanged, or otherwise disposed of, and the extension of time for payment of the tax will cease to apply. Subparagraph (h)(1)(D) of the Section goes on to say that a transfer of property to a person entitled to receive it "under the decedent's will or under the applicable law of descent and distribution" will not apply to cause an acceleration of the payment of the tax. This language apparently excludes a transfer to a beneficiary from a revocable trust established by an individual during his lifetime. Consequently, a very serious question is raised as to whether a trust will be able to avail itself of the benefits of Section 6166A on the same basis as a probate estate where there is a Will or intestacy. Subparagraph (h)(1)(D) discriminates against the individual who chose to avoid probate by the use of a trust.

(2) Section 2032A which related to "special use valuation" of farms and real property used in closely held businesses. The Committee Report of the House of Representatives gives the reason for the enactment of this Section and states that, "When land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential 'highest and best use' especially since it is desirable to encourage the continued use of the property for farming and other small business purposes."

There are indications that Section 2032A may be used only where there is a probate estate. Thus, Paragraph (a)(1)(B) requires that an election to utilize the section be made by an "executor." Where there is a trust, there would be no executor, but rather a trustee. In addition, the Committee Report also makes reference to an election being made by the executor. It further, in a heading in the Report, refers to "Qualification by Estate." Estate presumably is intended to mean a probate estate.

Although a trustee of a trust could make a reasonable argument that the benefits of Section 2032A should also be available to a trust, there is a wide area of doubt as to whether the argument would prevail.

I believe there will be frequent instances where individuals who want to set up a revocable, living trust to avoid probate will feel compelled to refrain from doing so because of the doubt about the availability of the use of Sections 6166A and 2032A. This should be corrected by legislation action by the Congress.

I would like to suggest that you have your staff review the matters I am discussing in this letter. I also wish to request that you take the initiative in having these sections amended appropriately.

I will look forward to hearing from you. Informing me as to your views relative to Sections 6166A and 2032A will be especially appreciated.

Sincerely yours,

ALAN D. PAUW,
Certified Public Accountant.

SEARS, ROEBUCK AND CO.,
Chicago, Ill., August 14, 1980.

Re S. 2775.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Sears, Roebuck and Co. recommends that the Subcommittee on Taxation and Debt Management Generally report S. 2775 favorably. This would remove the bias favoring unfunded pension plans covering nonresident alien employes of domestic employers.

Sears maintains pension plans in seven foreign jurisdictions, covering nationals who are residents in such foreign jurisdictions. All of the foreign pension plans are typical pension plans under the local laws and customs.

Because of the specific statutory requirements for qualification under ERISA, it is doubtful that any of these plans could qualify under ERISA if they were funded, even though all of them would comply with the laws of the local jurisdictions.

Section 4(b)(4) of ERISA exempts a foreign pension plan maintained outside the U.S. primarily for the benefit of nonresident aliens from coverage under Title I of ERISA. However, a funded plan is not exempt under Title II and therefore, employer contribution deductions are subject to the provisions of Section 404 of the Internal Revenue Code.

If Sears foreign pension plans were funded, Sears would never obtain a U.S. tax deduction for contributions to or payments from the foreign pension trusts. Section 404(a)(5) of the Code will allow a tax deduction only if a separate account is maintained for each employe. Under a typical pension plan, separate accounts are never maintained for each employe. Further, if a foreign trust were set up, Section 679 of the Code would appear to treat Sears as the owner of the property and taxable on all income earned by the trust.

In view of the foregoing, a domestic employer who wishes to grant pension coverage to its nonresident alien employes is discouraged from using a funded pension arrangement.

Sears urges the Subcommittee to report S. 2775 favorably in order to remove the bias for maintaining unfunded plans. In many instances, employers wish to maintain funded plans in order to fix their liability annually, especially in view of the fluctuating foreign exchange rates. Passage of S. 2775 will enable employers to satisfy this objective.

Sincerely,

RAYMOND P. BILGER,
Vice President, Taxes.

STANDARD OIL CO. (INDIANA),
Chicago, Ill., August 26, 1980.

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

Dear Sir: We have been asked to provide Senator Byrd's Committee with the attached letter—written in support of H.R. 7263, the companion bill to S. 2775,—as written testimony in support of S. 2775, a Bill to amend the Internal Revenue Code

of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

J. J. GOBEL,
Chief Tax Counsel.

Attachment.

STANDARD OIL CO. (INDIANA),
Chicago, Ill., June 30, 1980.

COMMITTEE ON WAYS AND MEANS,
Subcommittee on Select Revenue Measures,
House of Representatives, Washington, D.C.

DEAR SIRS: Pursuant to your Notice of Hearing on Minor Tax Bills, dated June 13, 1980, this letter is intended as a written testimony in support of H.R. 7263, a Bill to amend the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens.

The problem presented to the Subcommittee arises, for example, when a U.S. corporation operating abroad establishes a pension the company files both U.S. and foreign income tax returns, and seeks to deduct its contributions to the plan in both returns. Although the plan satisfies the requirements of the foreign government for a foreign tax deduction, it will not qualify for a U.S. tax deduction (according to the Revenue Service) unless the plan is conformed to ERISA requirements.

In brief, H.R. 7263 resolves the problem by permitting such U.S. deduction within broad safeguards and without regard to ERISA requirements. This exceptional treatment would be applied only to contributions to plans maintained primarily for foreign nationals. We support the Bill for the following reasons:

1. The problem arises from a legislative oversight in the 1974 enactment of ERISA. On the Department of Labor side, ERISA exempts plans for foreign nationals from its requirements by special provision. The tax treatment was intended to be consistent but Congress assumed erroneously that this could be achieved without a special provision in the Internal Revenue Code.

2. Experience has shown that foreign national employees are oriented to plan benefits different from typical U.S. patterns. Amending a plan for foreign nationals to comply with U.S. concepts could create foreign labor problems.

3. The burden of convincing a foreign government to conform to U.S. requirements involves long delays and uncertainty. Before a U.S. company can approach a foreign government, it must first know what constitutes an ERISA-approved plan. Although ERISA was generally effective in 1976, it was not until 1978 that this company had secured its first IRS approval. This approval was based on guidelines and proposed regulations which were later finalized in 1979, requiring another IRS approval in 1979. Many years may pass, therefore, before a U.S. company can even inform a foreign government what must be done to make plan contributions deductible in both countries.

4. The burden of keeping the plan in current compliance in two countries is intolerable. There are annual changes in U.S. law and regulations (such as ADEA) which must be presented for IRS approval and then agreed to by the foreign government. If the foreign government will not accept the changes verbatim, there is the problem of inducing the IRS to accept the foreign country modifications. This can be an endless cycle back and forth.

5. Foreign governments are often hostile to the imposition of U.S. rules as a matter of sovereignty. One major foreign country has insisted that the foreign plan be divided into two plans, one consisting of provisions acceptable without revision to both governments, and one consisting of provisions acceptable only to the foreign government. This solution is generally unworkable but it illustrates the reluctance of certain foreign governments to revise their plans to accommodate U.S. taxpayers.

We urge you, therefore, to give favorable consideration to H.R. 7263 as a means of correcting an oversight in the ERISA legislation and of curing an unreasonable disallowance of tax deductions.

J. J. GOBEL,
Chief Tax Counsel.

STATEMENT OF THE
FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION

This testimony is presented on behalf of the Forest Industries Committee on Timber Valuation and Taxation. Our Committee speaks on behalf of approximately 5 million forest-land owners of all sizes and from all regions of the country. For the purposes of this testimony we also represent 61 forest-related associations, including the American Paper Institute, American Plywood Association, American Pulpwood Association, Forest Farmers Association, Industrial Forestry Association, National Forest Products Association, and the Southern Forest Products Association. A list of the 60 associations is attached to this testimony as Appendix #1.

The principal public policy objective of the Committee is the attainment and preservation of equitable federal tax provisions to reflect the long-term nature of forest investments and the unique risks involved.

Part I of our testimony reviews the importance of an adequate timber supply to our national economy, the potential for increased forest productivity, and the reasons why timberland owners often find forestry investments to be economically unattractive.

Part II discusses why private, nonindustrial landowners are key to increases in timber productivity.

Finally, Part III reviews the special use valuation provisions of current law and makes recommendations with respect to S. 2967.

I. Ensuring Timber Supply: A National Goal

We start with the basic premise that ensuring an adequate timber supply is a vital national goal. However, the nation's timber needs will not be met if timberland owners do not have sufficient economic incentives to invest in forestry.

A. Timber Supply and Demand

The Forest Service projects that domestic paper and wood product demand will double between 1980 and 2030. Demand for paper and wood products is expected to reach 28.3 billion cubic feet in the year 2030, up from 13.3 billion cubic feet in 1976. Table I summarizes the projected supply/demand situation.

B. The Potential for Increased Forest Productivity

In May, 1980, the Forest Industries Council released its "Forest Productivity Report," which analyzes and makes recommendations for the improvement of forest productivity in the United States on a state-by-state basis. The study encompassed 25 states which contain 404.4 million acres of commercial forestland, 83 percent of the U.S. total.

TABLE I

Summary of U.S. supply and demand for softwoods and hardwoods in 1976 and for 2030 -- base level projection.1/

Category	1976	2030
	(billion cubic feet)	
Softwoods		
Total U.S. demand	10.3	18.7
Exports	1.3	0.9
Imports	2.4	3.9
Demand on U.S. forests	9.2	15.7
Supply from U.S. forests	9.2	12.3
Supply/demand balance	0.0	-3.4
Hardwoods		
Total U.S. demand	3.0	9.6
Exports	0.2	0.4
Imports	0.3	0.6
Demand on U.S. forests	2.9	9.4
Supply from U.S. forests	2.9	8.9
Supply/demand balance	0.0	-0.5
All timber		
Total U.S. demand	13.3	28.3
Exports	1.5	1.3
Imports	2.7	4.5
Demand on U.S. forests	12.1	25.1
Supply from U.S. forests	12.1	21.2
Supply/demand balance	0.0	-3.9

1/ Assumes price rises similar to those experienced from late 1950's to mid-1970's.

Source: USDA-Forest Service, January, 1980, An Assessment of the Forest and Range Land Situation in the United States.

1. Current Levels of Management

The Forest Productivity Report found that in the study states for which data was available, approximately 5 million acres were being harvested annually using various cutting methods. At the same time only 2.2 million acres were being purposefully regenerated, as shown on Table II.

TABLE II

Estimated annual average levels of forest management in the 25 study states by ownership, 1976-78.1/

Ownership	Planting or Seeding	Site Preparation for Natural Regeneration	Intermediate Stand Management	Harvest
		(thousand acres)		
National Forest	262.2	50.6	282.3	678.5
Other Public	106.4	28.8	116.2	188.9
Forest Industry	1,221.7	197.7	399.9	1,503.9
Other Private	265.1	49.2	118.0	2,784.9
Total	1,855.4	326.3	916.4	5,156.2

1/ Lake State and Border State regions excluded from table due to lack of adequate data.

The major gap between harvest and regeneration was for the private, nonindustrial ownership, where approximately 1 in 9 harvested acres were being purposefully regenerated.

It should be noted, however, that in some areas and under certain conditions, natural regeneration is a sound forest management practice. Nonetheless, it is still safe to conclude that regeneration on private, nonindus-

trial lands is not adequate to effectively replace the harvested stands. In addition, the report found that millions of additional acres exist which are presently nonstocked, inadequately stocked, or are softwood sites which are occupied with low quality hardwood species.

2. Investment Opportunities

The Forest Productivity Report found that there are a total of 139.2 million acres in the 25 study states which would provide investment opportunities with a 10 percent or better after-tax return. These opportunities for increased forest productivity would require an initial investment of $10.3 billion, which would increase annual growth by 10.9 billion cubic feet or 50 percent over current levels.

Approximately 72 percent of the investment opportunities (100 million acres) requires regeneration treatments.

C. Difficulty of Attracting Capital

Despite these opportunities for increased forest productivity, forestland owners often find that the arguments against forestry investments are overwhelming. You hear these kinds of comments:

1. I'll die before the trees are old enough to cut.

2. There is too much risk of fire, disease, and storms. Casualty loss insurance is simply not economically available on standing timber.

3. The initial capital investment costs (land preparation, roads, plantings) and annual maintenance costs are higher than ever before.

4. There is no annual income, like rents or dividends.

5. I'm scared that Uncle Sam will take whatever profits I make away from me with confiscatory taxes.

These are the handicaps which must be addressed by the Congress if we are to anticipate and prepare for the timber supply needs of the United States by the year 2030 and beyond. We cannot wait until the shortage is upon us to take remedial action. We will never find a way to grow a tree in that short a time.

D. Benefit to Society of Forestry Investments

1. Importance of Timber Growing to National Economy

The forest products industry is the nation's seventh largest in terms of value of product shipments. It is comprised of more than 35,000 companies with 40,000 production facilities providing employment for about 1.2 million workers. The value of shipments by these companies totaled $79.5 billion in 1976, about 6.7 percent of all U.S. manufacturing.

The Forest Service estimates that all economic sectors associated with wood and paper products provided employment for 27.5 million people and added over $324 billion in product values to the economy in 1972 (Table III).

TABLE III

Estimated value added and employment by total and that attributable to timber in timber-based economic activities, 1972.

Economic Activity	Value Added		Employment	
	Total	Attributed to timber	Total	Attributed to timber
	(billion dollars)		(million people)	
Timber management	2.9	2.9	0.1	0.1
Harvesting	3.1	3.1	0.2	0.2
Primary manufacturing	10.1	8.8	0.5	0.4
Secondary manufacturing	34.0	12.5	2.7	0.9
Construction	79.6	11.9	5.3	0.8
Transportation and marketing	194.2	9.3	18.7	0.8
Total	323.9	48.5	27.5	3.2

Source: USDA-Forest Service, Unpublished.

For every job and dollar invested in growing timber, an additional 28 jobs and $17 were generated before the product was finally consumed.

Thus, an incentive to help private timberland owners manage their lands rather than neglecting them will benefit the entire nation. The "ripple" through other industries will create wealth and add to the national tax base.

2. Environmental Considerations

Unlike other basic resources, forests are renewable. Timber, a storehouse of solar energy, is most compatible with man's use in his present environment because of its strength, its versatility, its ease of production, and its biodegradability.

In addition to the quality of renewability, wood has significant environmental advantages over other materials in the processing stage. Timber products are produced and processed with much lower energy requirements and with relatively little adverse environmental effect. Processing steel for construction, for instance, takes four times the energy of processing lumber for the same purpose. For aluminum, it takes 20 times the energy.

Production of wood substitutes also creates more air, water and solid waste pollution than does the production of wood. Much of wood fiber can be recycled. What is not is biodegradable and returns to the earth. Charts I and II compare the low energy and pollution cost of processing solid wood products compared with other substitutes.

CHART I

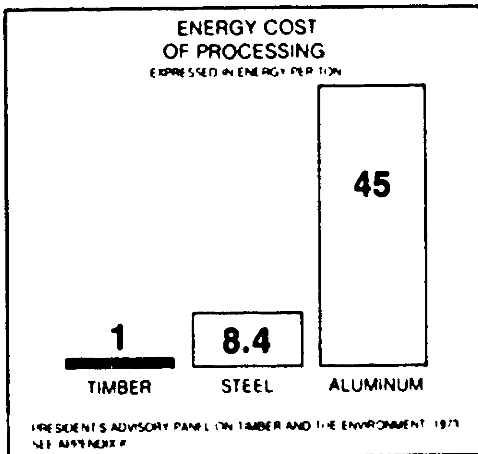
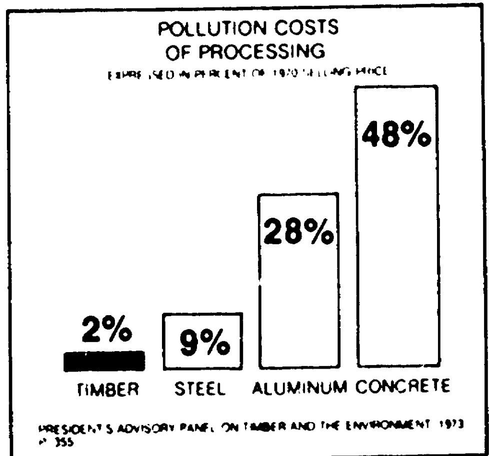


CHART II



Moreover, timberlands help provide a home for our wildlife, support livestock herds, provide recreational opportunities, and are an important element in the conversion of carbon dioxide to oxygen.

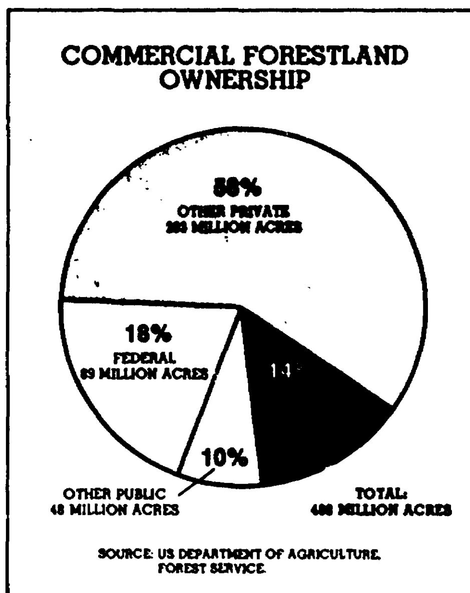
3. Impact on Inflation

If our tax policies create a reduction in timber production, severe shortages may result. Such shortages can exert pressure on the price of wood building materials and housing, with the effects being felt throughout the entire economy.

II. Increase in Timber Supply Must Come From Private Nonindustrial Landowners

Chart III shows the distribution of forestland ownership in this country. Of the categories shown, the greatest potential for increased production comes from the 283 million acres owned by approximately 5 million private landowners. In general, these lands are not intensively managed for timber production and produce wood at only about 63 percent of their potential.

CHART III



In contrast, public lands are under constant pressure for uses other than commercial forestland, harvest levels are nearly static and funds perennially have not been provided for adequate forest management. The industry lands comprise only 14 percent of the total and are producing at close to their full potential. It is therefore clear that the largest area of potential improvement comes from the private, nonindustrial landowner.

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The U.S. Forest Service's "1980 Report to Congress on the Nation's Renewable Resources" addresses the situation as follows:

> The most critical demand on the Nation's timber will be for softwood sawtimber while public lands will continue to play a major role during the decade of the 80's. The best opportunities to increase softwood supplies are on private non-industrial forest land. The leveling off of harvests from industrial land accentuates the importance of nonindustrial private land. It is here that much of the increased demand for softwood would be met through increased harvest and reforestation.

III. Special Use Valuation of Timberlands for Estate Tax Purposes

The preceding sections of this testimony show the importance of increased timber productivity on our nation's private, nonindustrial forestlands. Estate taxes have become increasingly significant in influencing the investment decisions of private, nonindustrial timberland owners. And in considering estate taxes, one of the important factors is the manner in which the timber and timberland is valued.

A. Impact of Estate Taxes Generally on Timber Growing

Because of the long growing period for timber, estate taxes have a particularly large impact on private forestland owners. Depending on the region, tree species and forest management practices, timber crops take between

15 and 50 years to reach harvestable size. This lengthy growing period often results in timber passing through several estates between planting and harvest. It is in such situations that the impact of estate taxes is most severe.

The importance of the long growing period for timber is underscored by an American Forest Institute survey which shows that 37 percent of all tree farmers in 1972 were over 60 years old and 28 percent were between 50 and 60 years of age. These statistics indicate that the families of 65 percent of the owners of private forestlands could be involved in estate tax proceedings between now and the end of the century. Thus, the impact of estate taxes may be larger for timber owners than for other sectors of our economy.

B. Importance of Special Use Valuation

In determining the magnitude of a timber owner's estate tax liability, the most crucial question will often be "What is the value of the timberland in the estate?" More specifically, is the timberland to be valued based on its current use as timberland? Or should the value be based on the property's highest and best use as residential property, or as a ski resort, or as a shopping center?

The argument of timber owners who desire special use valuation of timberlands is really quite simple. They believe that (1) land which has been and will continue to be used to grow timber and (2) which will continue to be used for that purpose in the future should (3) be valued for estate tax purposes as timberland. To do otherwise provides an unjustified windfall to the federal government.

The difference between current use valuation and highest and best use valuation can be quite large. Depending on the location of the land and the alternative uses for it, highest and best use valuation can be as much as 300 percent or 400 percent higher than the valuation as timberland.

For these and other reasons, many states have enacted property tax laws which value timberlands based on their current use rather than highest and best use.

C. Why Special Use Valuation Provisions of 1976 Tax Reform Act Are Inadequate; Suggested Changes

Prior to the Tax Reform Act of 1976, one of the most adverse factors used in determining the fair market value of timberland was the highest and best use to which the land could be put. The 1976 Act, however, provides

that if certain conditions are met, the executor may elect to value qualified property (including timberlands) based on its current use rather than its highest and best use.

The House Ways and Means Committee, in its report on the 1976 Act, explained the reasons for this change as follows:

> Your committee believes that, when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential 'highest and best use' especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, your committee believes it unreasonable to require that this 'speculative value' be included in an estate with respect to land devoted to farming or closely held businesses.

Unfortunately, the restrictions which must be satisfied before property qualifies for special use valuation have proven so onerous that in many instances the

Congressional intent has been thwarted. The following three restrictions have proven to be most troublesome to timberland owners: (1) that the decedent or member of the decedent's family must have materially participated in the operation of the woodlands for five out of the eight years immediately preceding the decedent's death, (2) the value of the woodlands or other closely held business assets in the decedent's gross estate, including both real and personal property, must comprise at least 50 percent of the decedent's total gross estate, and (3) the special use valuation cannot reduce the decedent's gross estate for tax purposes by more than $500,000.

S. 2967 would make a number of equitable changes with respect to estate taxes generally and special use valuation in particular. The comments which follow are addressed to the special use provisions which are of most concern to timberland owners.

1. MATERIAL PARTICIPATION RULE

Timber owners often have a particularly difficult time meeting the requirements of the material participation rule, i.e., showing that the decedent materially participated in the management of the property for five out of the eight years immediately preceding his death.

On many occasions a timber owner will be advised by his consulting forester to simply leave the timber alone for several years and let it grow. Under such circumstances, how can the timber owner show that he has materially participated in managing the property under the present IRS regulations?

The final IRS regulations on material participation include many factors which are not appropriate for woodlands. These include the following:

a. <u>Physical Work on the Property</u>

Such work is relatively rare for timber owners because of the technical nature of the work to be done. For example, the owner may hire a registered surveyor to do a survey of the boundary lines or a professional forester to make a timber cruise or to mark the trees for sale. He may also retain a contractor to make improvements to the logging roads. Often it is necessary for a timberland owner to hire an individual to complete site preparation and planting of seeds or seedlings.

Tree farming is rarely a full time job and the timber owner often lives in or near a city where he has full time employment. As a result, physical work on the property is far less practical than if he lived nearby and had the free time to do the work himself.

b. Furnishing Machinery Used in Relation to the Property

A great deal of heavy and expensive equipment is used to harvest trees from the forest. It is also necessary to use heavy and expensive equipment in the construction of roads and to haul the wood to the various markets. Other equipment is necessary for site preparation and the planting of seeds and seedlings. It would be impractical for the timber owner to invest the vast sums of money required to purchase machinery for the wide range of forestry activities, particularly for an individual who has a relatively small ownership.

c. Maintenance of Decedent's or Heir's Principal Place of Residence on the Premises

Most of the private timberland in this country is located some distance from towns or cities. There are quite often no schools, churches, stores, or power near these properties and it would be impractical to live so far away from the amenities of civilization.

These factors and other references in the regulations underscore the need to make changes in the law itself as it relates to the material participation rule.

S. 2967 would provide an alternative to the material participation rule for woodlands. Under S. 2967,

there would be sufficient management participation in the case of woodlands if:

(1) the woodlands are owned by the decedent or member of the decedent's family for the 10 years immediately prior to the decedent's death and

(2) "the decedent or a member of the decedent's family was engaged in the active management of the operation of the business." Active management is defined in S. 2967 as "the making of the management decisions of a business (other than the daily operating decisions)."

There is considerable confusion and uncertainty on the part of timber owners as to what is required under this "active management" test. The Forest Industries Committee on Timber Valuation and Taxation hopes that this language can be clarified to reflect the concerns outlined above. The Committee looks forward to working with the staff of the Senate Finance Committee to reach an appropriate resolution to this difficult issue.

2. 50 PERCENT TEST

The second onerous requirement for timber owners is that at least 50 percent of the decedent's gross estate must

be comprised of qualifying real and personal property [i.e., property devoted to the "qualified use" of farming (including woodlands)].

For many years, estate planners have encouraged timber owners to diversify their interests and not to place all of their capital in timberland. They recognize the ever-present possibility that disaster might strike--that trees will be killed or infected by pine beetles, or tussock moths, or budworms; or that an Act of God, such as an ice storm, hurricane or flood will destroy or severely damage the investment.[1/] And insurance is not available to provide protection against such casualties. Accordingly, many

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1/ Hurricane Frederic, which ravaged the Gulf Coast States on September 12, 1979, provides a vivid reminder of the impact which hurricanes and other disasters can have on timberland owners. The estimated timber damage in Alabama alone as a result of the hurricane was $333.4 million. This amount exceeds the average annual timber cut in Alabama of $225 million.

It is estimated that only 40 percent of the damaged timber will be able to be salvaged. The remainder will be lost due to deterioration or insect infestation.

In Mississippi the loss was also substantial--$116.9 million.

There were many instances where stands of excellent sawtimber, which were valued at approximately $200 per thousand board feet the afternoon before the hurricane hit, were reduced to pulpwood valued at $15 per cord the following morning. (Footnote continued on p. 21.)

individuals who are deeply involved in tree farming and who should be able to qualify for special use valuation will not be able to do so because they diversified their investments and therefore fail to satisfy the 50 percent test.

S. 2967 would leave the 50 percent test unchanged. The Forest Industries Committee recommends that the 50 percent test be either repealed or reduced to a more realistic level of 25 percent.

3. $500,000 LIMITATION

Finally the 1976 Act provides that special use valuation cannot reduce the decedent's gross estate for tax purposes by more than $500,000. This restriction has greatly reduced the utility of the special use valuation provisions.

We believe that if land has been used as timberland for many years and will continue to be used as timberland, then it should be valued for estate tax purposes as timberland

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(1/ continued from P. 20.) Hurricane Camille, which struck the Gulf Coast almost exactly one decade earlier, had an impact almost as great as Hurricane Frederic.

Hurricanes are not the only source of casualty losses for timber owners. Fires, for example, can wipe out an investment overnight. The Forest Service estimates that between 1973 and 1977, there were an average of 162,879 fires reported each year on all commercial forestlands, burning an average of 3.1 million acres per year.

rather than as a skiing resort or residential development. This should be the case regardless of whether the valuation as timberland is $5 thousand or $5 million less than the highest and best use valuation.

S. 2967 recognizes this principle and would remove the $500,000 limitation. We strongly support that objective.

IV. Conclusion

All tree planters, from the small tree farmer to major corporations, have one thing in common--a very uncommon faith in the future. To spread that faith, we must take steps to encourage sufficient investment in timber growing to meet tomorrow's needs. Every year we delay in implementing more adequate policies means a year of delay in providing adequate future wood supplies.

Providing fair and equitable estate tax treatment of timberlands is one important step which can be taken. We are appreciative of the efforts of Members of the Senate who recognize the effect of estate taxes on timber growing and look forward to working with the Senate Finance Committee on the recommendations outlined in this testimony.

Appendix #1

COOPERATING ASSOCIATIONS

NATIONAL ASSOCIATIONS

American Institute of Timber Construction

American Paper Institute

American Plywood Association

American Pulpwood Association

American Wood Preservers Institute

Associated Cooperage Industries of America, Inc.

Federal Timber Purchasers Association

Fine Hardwoods-American Walnut Association

Hardwood Dimension Manufacturers Association

Hardwood Plywood Manufacturers Association

National Christmas Tree Growers Association

National Forest Products Association

National Hardwood Lumber Association

National Oak Flooring Manufacturers Association

National Particleboard Association

REGIONAL ASSOCIATIONS

Appalachian Hardwood Manufacturers, Inc.

Forest Farmers Association

Industrial Forestry Association

Northeastern Lumber Manufacturers Associations, Inc.

Northern Hardwood and Pine Manufacturers Association, Inc.

Pacific Logging Congress

Southeastern Lumber Manufacturers Association

Regional Associations (continued)

Southern Forest Products Association

Southern Hardwood Lumber Manufacturers Association

Southwest Pine Association

Western Forest Industries Association

Western Forestry and Conservation Association

Western Timber Association

Western Wood Preservers Institute

Western Wood Products Association

STATE ASSOCIATIONS

Alabama Forestry Association

Alaska Loggers Association, Inc.

Arkansas Forestry Association

Associated Oregon Industries

California Forest Protective Association

Eastern North Carolina Lumber Manufacturers Association, Inc.

Florida Forestry Association

Georgia Forestry Association, Inc.

Kentucky Forest Industrial Association

Louisiana Forestry Association

Lumber Manufacturers' Association of Virginia

Maine Forest Products Council

Maine Hardwood Association

Minnesota Timber Producers Association

Mississippi Forestry Association

State Associations (continued)

Missouri Forest Products Association

New Hampshire Timberland Owners' Association

New York Forest Owners Association

North Carolina Forestry Association

Oklahoma Forestry Association

Oregon Forest Protection Association

Society for the Protection of New Hampshire Forests

South Carolina Forestry Association

Southern Oregon Timber Industries Association

Tennessee Forestry Association

Texas Forestry Association

Timber Producers Association Inc. of Michigan and Wisconsin

Virginia Forestry Association

Washington Forest Protection Association

PROFESSIONAL AND PUBLIC INTEREST ASSOCIATIONS

Association of Consulting Foresters

STATEMENT OF THE ASSOCIATED EQUIPMENT DISTRIBUTORS, PRESENTED BY ROBERT R. STATHAM [1]

The Associated Equipment Distributors appreciates this opportunity to present its views with respect to S. 2805, introduced by Senator Gaylord Nelson, which would provide that IRS Revenue Ruling 80-60 shall not require a change in the taxpayer's method of accounting for taxable years beginning before 1980. The ruling would implement the Supreme Court Case of *Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522 (1979).

The Associated Equipment Distributors is a national trade association comprised of nearly 1,100 distributors and 500 manufacturers of construction, mining and logging equipment and machinery. AED members, the vast majority of which are small, independent businesses, sell, rent and service a wide variety of construction equipment ranging from small pumps to large cranes. We are intimately involved in this nation's largest industry, the construction industry. We feel that this industry, more than any other, is bearing the brunt of current economic conditions, and we suggest that our nation's economic future is in large part dependent on the future of this basic industry.

The Associated Equipment Distributors supports S. 2805 and urges its prompt enactment. Retroactive tax rulings are bad tax policy and should be avoided. We do not agree with the approach which has been taken by the Treasury Department in this regard, and we urge that Congress take action immediately to delay the effective date of Revenue Ruling 80-60.

On January 16, 1979, the U.S. Supreme Court announced its decision in the case of *Thor Power Tool Co.* v. *Commissioner.* In *Thor,* the taxpayer had in 1964, in

[1] Partner in the Washington, D.C., law firm of Statham & Buek and tax counsel to the Associated Equipment Distributors.

accordance with generally accepted accounting principles, written down what it regarded as excess inventory to its own estimate of the net realizable value of the excess goods. The taxpayer then continued to hold the goods for sale at original prices. It offset the write-down against 1964 sales and thereby produced a net operating loss as a carryback to 1963.

The Internal Revenue Service, maintaining that the write-down did not serve to reflect income clearly for tax purposes, disallowed the offset and the carryback. The Supreme Court said conformance with generally accepted accounting principles was not enough, the law requires that for tax purposes inventory accounting methods must clearly reflect income, and the Commissioner of Internal Revenue Service had not abused his authority in determining that a practice different from generally accepted accounting principles reflected income clearly.

It is not our purpose to be critical of the decision handed down by the Court. This is not the time nor the proper forum for such a discussion. However, it is our purpose to voice concern for the method of implementation of the decision by the Treasury and the Internal Revenue Service.

At the time of the *Thor* decision, there apparently were a large number of taxpayers who were writing down excess inventory using similar accounting methods used by *Thor.* Using the reasoning of Treasury, on January 16, 1979, the day the Supreme Court announced its opinion in *Thor,* those taxpayers should have changed their accounting system to conform with the Court's decision.

However, the Internal Revenue Code at section 446(e) provides that a "taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books, shall, before computing his taxable income under the new method, secure the consent of the Secretary [of the Treasury]." The wording of the statute is clear. A taxpayer who changes his method of accounting must obtain consent. However, Treasury argues that if the taxpayer concludes that his method of accounting is improper, he need not obtain consent. Where does it say that in the statute?

Obviously the Internal Revenue Service must not have been so certain of the interpretation to be given to section 446(e), for in its Revenue Procedure 80-5, issued on February 8, 1980—over one year after the *Thor* decision was announced, the Internal Revenue Service gave consent on a blanket basis for taxpayers affected by *Thor* to change their accounting method.

Treasury in its arguments admits that many in the business community watched *Thor* as the case advanced in the judicial ranks. So Treasury must have known the ultimate decision in *Thor* would be a landmark opinion, and if the Government prevailed that it would cause major compliance problems for many taxpayers. Instead, it was obviously unprepared in January of 1979 to provide guidance to taxpayers, and it was not until February of 1980 that it came out with guidance to taxpayers obviously placing taxpayers in an impossible position to use proper planning and sell off or offer for sale their excess inventory in 1979. Then as though taxpayers knew all along how the Treasury would implement *Thor,* the Treasury made its procedure retroactive to 1979.

The retroactive tax procedures inflicted on the taxpayers by the Internal Revenue Service to implement the *Thor* decision is another example of the encroaching needless burden of the Federal Government on the business community. It is this blatant disregard of the mounting burden of complexity and the cost of compliance that is literally breaking the back of the small businessman. If relief cannot be given in this instance, where is to come?

We endorse S. 2805 and urge its prompt enactment.

UNION CARBIDE CORP.,
New York, N.Y., August 12, 1980.

Re Foreign pension plans—S. 2775.

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

DEAR MR. STERN: Union Carbide Corporation strongly supports the enactment of S. 2775 the Senate Bill on Foreign Pension Plans.

The bill would remove the inequities that would result from the attempts by the Internal Revenue Service to have pension plans around the world conform to the requirements of United States tax law for "qualified" plans. Pension plans maintained primarily for the benefit of persons substantially all of whom are nonresident aliens have been explicitly excluded from the coverage of ERISA, and S. 2775 would effectively recognize this exclusion in applying the tax rules for "qualified" plans as well.

If the bill is not enacted, U.S. corporations with subsidiary operations abroad will be at a serious disadvantage compared to their non-U.S. competitors in light of both the high cost and the difficulty of compliance with U.S. "qualification" rules for foreign pension plans. This would result in an undesirable loss of U.S. position and a needless decline in exports from the U.S.

Therefore we urge the Senate to act favorably.

Sincerely,

J. S. FREEMAN,
Vice President.

UNITED STATES STEEL CORP.,
Pittsburgh, Pa., August 13, 1980.

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

DEAR MR. STERN: This is to advise that we support S. 2775 amending the Internal Revenue Code of 1954 with respect to the treatment of retirement and similar plans maintained for nonresident aliens. Accordingly, we submit this statement for inclusion in the record of hearings held on August 4, 1980, on Senate Bill 2775.

We strongly urge prompt enactment of this bill which in a welcome measure conforms the treatment for these plans under the Code to the existing exemption of such plans from Title I of the Employee Retirement Income Security Act of 1974 (ERISA).

Deductions to retirement plans maintained by United States persons for nonresident aliens should not depend upon whether the plan meets ERISA standards. It is quite common for U.S. domestic corporations to do business in one or more foreign countries through branch offices or subsidiaries with nonresident alien employees. In view of conflicting tax or social security law requirements and/or competitive employment factors, the adoption of separate employee benefit plans for these groups of employees is a practical consideration and in some instances a necessity. The administrative problems and expense inherent with maintaining U.S. tax qualification status under dual national tax requirements for retirement plans for small groups of such employees is prohibitive.

If a foreign pension plan is not qualified under Section 401(a) of the Code, there are many instances when a U.S. taxpayer is forever denied a deduction for contributions to or payments out of the foreign pension trust. Section 404(a)(5) of the Code provides that contributions to a non-qualified trust are deductible when they are includible in the gross income of the employees, but only if the plan is a separate account plan. Since most pension plans are not separate account plans, no deduction is ever available.

Plans "maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens" are exempt by section 4(b)(4) of ERISA from all requirements of Title I of ERISA. There is, however, no parallel provision in the Code. We submit that had Congress had the time to focus adequately on the matter, such plans would have been exempted from the ERISA amendments to the Code. This belief is based on the ERISA Conference Report suggesting that the Code does not exempt foreign plans from the ERISA standards because "such plans would have no need to seek tax deferral qualification". H.R. Rep. 93-1280, 93d Cong., 2d Sess. 291 (1974). This analysis is at best, incomplete; it ignores the problems of deduction of contributions to foreign plans and of taxation to U.S. employers of the income of such plans and the fact that foreign plans often cannot comply with the ERISA requirements.

There can be no question that a U.S. employer should be able to deduct the cost of foreign pensions at some point. S. 2775 assures that contributions to foreign plans would be deductible under the conditions it specifies and it should be favorably acted upon by the Congress at the earliest possible moment.

Five copies of this statement are submitted herewith for consideration by your Committee.

Respectfully submitted,

ROY G. GOURLEY,
Tax Administrator.

68-883 O - 80 - 32

MONTGOMERY WARD,
Washington, D.C., August 22, 1980.

Re President's disapproval of import relief to the domestic leather coat and jacket industry.

Hon. ABRAHAM RIBICOFF,
Chairman, Subcommittee on International Trade,
U.S. Senate, Washington, D.C.

DEAR SENATOR RIBICOFF: Montgomery Ward appreciates this opportunity to present its views to the Subcommittee on the above-referenced matter. This statement is submitted for inclusion in the printed record of the hearings.

In its January 24, 1980, Report to the President, the International Trade Commission recommended that he increase the present duty on leather coats and jackets dramatically over the next three years. On March 24, 1980, President Carter decided to deny import relief because such action would be inflationary and provide only dubious relief to the domestic industry.

Montgomery Ward believes that President Carter's decision to deny import relief is economically sound. Indeed, in its comment to the Trade Policy Committee, Wards set forth arguments and data demonstrating that this "proposed remedy" would increase consumer prices sharply, reduce product availability, significantly injure Wards and other retailers, and all without effecting long term improvements in the domestic leather-wearing apparel industry. This comment remains probative and Wards attaches it for your consideration.

Thus, Montgomery Ward maintains that the evidence overwhelmingly supports President Carter's determination that the ITC's proposed remedy is unwarranted and injurious to the national economic interest.

Yours very truly,

PETER K. PITSCH, *Attorney.*

Enclosure.

February 12, 1980

Secretary
Trade Policy Staff Committee
Room 728
Office of the U.S. Trade Representative
1800 G Street, N.W.
Washington, D.C. 20506

RE: Leather Wearing Apparel
Investigation No. TA-201-40

Dear Sir:

In its January 24, 1980 Report to the President, the International Trade Commission found that imports have seriously injured the domestic leather coat and jacket industry and recommended that the present duty of six per cent _ad valorem_ on these items be increased by 25 points in the first year, 20 points in the second year, and 15 points in the third year. Montgomery Ward vehemently opposes this proposed remedy because it would substantially increase consumer prices and reduce product availability, significantly injure Wards and other retailers, and not promote long-term improvements in the domestic leather wearing apparel industry.

Effect on Consumers

The proposed tariff hikes would seriously injure consumers by sharply increasing prices and product unavailability. Montgomery Ward has attempted, in the short time since the release of the ITC Report, to estimate the potential dollar loss to its customers.* These estimates range between 1.5 and 3.2 million dollars in 1980 alone. These figures include both the effect of price increases and the dollar value of the consumer surplus attributable to the foregone purchases of those consumers priced out of the leather wearing apparel market. If the same dollar loss to sales ratio prevails in the domestic industry as a whole, the potential dollar loss to consumers would, in the first year alone, be a staggering 8 to 17 per cent of the current dollar sales of leather coats and jackets.

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* An explanation of these estimates is contained in the Appendix.

Trade Policy Staff Committee
February 12, 1980
Page Two

These potential estimates are plausible because it appears that domestic producers will be unable to fill the current domestic demand at anything close to existing prices. There are three reasons for this gloomy assessment.

First, from 1977 to 1979, U.S. shipments have constituted about one fourth of the total U.S. market. The following table, based on figures used in the ITC Report, gives the precise percentages.*

Year	Imports	U.S. Shipments	U.S. Shipments as a fraction of total consumption
	(In thousands)		
1975	3972	2523	.3885
1976	6019	2580	.3000
1977	6432	2299	.2633
1978	9784	2212	.1844
January-August:			
1978	5777	1503	.2065
1979	4338	1223	.2199

Thus, given existing levels of demand, the domestic producers would have to triple or quadruple production to keep prices from rising.

Even adding in the unused capacity of the domestic industry does not significantly improve this picture. For example, if in 1978 (when the domestic industry's capacity was only 70.6 per cent) the domestic industry had operated at 100 per cent capacity, it would have filled only 26.1 per cent of total consumption - an increase of 7.7 points.

Second, the ability of the domestic industry to expand production even at higher prices is at least questionable. Although the ITC Report contends that the leather wearing apparel industry has low entry costs,** it does not say whether there are adequate machines and facilities in the short run to triple or quadruple domestic production. For instance, although the Report states that the "heavy-duty

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* ITC, Leather Wearing Apparel, Investigation No. TA-201-40, January 1980, p. A-13.

** ITC Report at A-7 n.1.

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Page Three

sewing machines used to sew leather garments can be adapted in most cases, and with some loss of efficiency, to sew other leather articles and/or cloth garments",* the implication is that lighter cloth sewing machines cannot be used for leather garments. If this relationship holds, the Trade Policy Committee should clarify whether the sewing machine manufacturers can satisfy the predictable increased demand for machines and at what increase in price. At this point, it appears probable that at least in the first year the domestic industry will be unable to expand production sufficiently to keep the prices of leather wearing apparel from increasing precipitously.

Third, even if the domestic industry can quickly expand production, its prices are likely to be sharply higher. On balance, they already have higher prices than imports. In this regard, the ITC Report states:

> "Average unit values of imports are significantly lower than those of domestic producers' shipments even after the import values are adjusted with c.i.f. charges, duty and importer markup."**

Although this difference in average price may be attributable in part to differences in quality, the primary explanation appears to be higher costs of operation. As the ITC Report notes, the foreign producers enjoy significantly lower labor costs.*** Furthermore, any existing differences in the cost of operation will surely be exacerbated when the domestic industry's capital, material, and labor costs rise in order to attract the additional resources that will be needed to expand production.

Thus, because of the domestic industry's small share of the market, various unknowns about its ability to expand production quickly, and the likelihood that its already high operation costs would increase substantially, Montgomery Ward fears that the proposed tariff hikes will cause sharp increases in leather wearing apparel prices and price many consumers out of this market.

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* <u>ITC Report</u> at A-17.

** <u>ITC Report</u> at A-26.

*** <u>ITC Report</u> at A-8.

Effect on Retailers

Montgomery Ward and other retailers of leather wearing apparel will suffer two ill effects from the proposed tariff hike: (1) the higher prices will sharply reduce sales in all three years, and (2) because many orders for leather goods antedated the ITC Report, retailers will suffer significantly lower profit margins in the first year of the proposed remedy.

First, as the above analysis of the effect on consumers demonstrates, the proposed tariff hike will increase prices and reduce sales. Consequently, sales during the next three years will be sharply off and retailers will be adversely affected. As set forth in the Appendix, unit sales could fall as much as 28 per cent. Along these lines, it should be noted that retailers' marketing and promotional efforts have helped create a market for leather wearing apparel. If the tariff increases and the concomitant higher prices make leather goods less attractive for retailers to market and promote, the remedy could have a depressing effect on the leather wearing apparel market (including domestic production) that would persist beyond its proposed three years.

Further, the effect of the tariff hike in the first year could have a particularly serious effect on retailers' already slim profit margins. Because many leather goods orders were placed last November and December, retailers will be unable to adjust to the changed market conditions. If these early-ordered goods are assessed at a 31 per cent duty, then retailers will have to shrink their profit margins to sell the suddenly more expensive imports. Accordingly, Montgomery Ward believes that the Trade Policy Committee should recommend that the remedy apply to those goods ordered after a final proposal is effective, if ever.

Effect on the Domestic Industry

Finally, Montgomery Ward opposes the ITC's proposed remedy because the beneficial effects on the domestic industry will be ephemeral, perhaps in the long run harmful, and in any event, substantially smaller than the expected injury to consumers and retailers.

The ITC Report provides little basis for believing that the proposed remedy will promote long-term improvements in the position of the domestic industry. As we have already stated, the Report itself documents that the domestic leather

wearing apparel producers have higher costs and higher prices. Furthermore, during the period of the proposed remedy, these costs and prices will surely increase. However, when the arbitrary price advantage provided by tariff increases is lost, any expanded domestic production will once again have to meet the remorseless test of free and open competition. Without real improvements in efficiency during the course of the remedy, more rather than fewer firms and workers could be disadvantaged.

The 45-page summary of the ITC investigation provides little comfort on this score. It devoted one short paragraph to the "Efforts of U.S. leather wearing apparel producers to compete with imports."* Only 14 producers responded to the ITC's inquiry concerning their efforts made to better compete with imports. The firms' responses are neither specific nor promising.** But more importantly, they beg the questions: Why could not these improvements have been implemented earlier? Why, if they will make their operations more efficient, could they not be done in the absence of a tariff? Thus, to the extent significant improvements are made, they cannot be attributed to the remedy. On the other hand, if no meaningful improvements are made in the competitive posture of the domestic industry, then any expanded domestic production caused by the tariff hikes will be cruelly curtailed when the remedy expires.

In this vein, it should be observed that the primary effect of increased imports has to date been to expand the total market rather than displace existing domestic production and workers. From 1975 to 1978, imports expanded 246 per cent (5,812,000 units) while U.S. shipments decreased

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* ITC Report at A-41

** The Report states: "Of the 14 producers which responded, five stated that they have established offshore facilities and have begun to import leather and leather garments to lower unit costs and fill-in product lines. Five firms cited improvements or purchases of new machinery to increase efficiency, and four firms mentioned efforts to cut materials and production costs. Other efforts mentioned by the respondents included expansion of sales forces, increased emphasis on styling, and the installation of computerized investory and billing systems." ITC Report at A-41.

by only 12.3 per cent (311,000 units)!* Likewise, employment during this period was only slightly affected. The ITC Report states:

> [E]mployment of production and related workers in the leather wearing apparel industry almost certainly rose from 1975 to 1976; it then remained stable in 1977 and declined slightly in 1978. Employment of production and related workers declined 15 per cent in January-August 1979, compared with employment in the corresponding period in 1978. The average hours worked per week by production and related workers in the leather wearing apparel industry remained stable from 1975 to 1978 at a little over 33 hours per week, suggesting some underemployment in the industry.**

Nonetheless, the proposed remedy, by creating an artificial price advantage, will attract new firms and new workers. When the price advantage created by the tariff vanishes, the business and job opportunities will also disappear. Consequently, rather than benefitting the domestic workers, the proposed remedy may unfairly attract new workers whose jobs will be eliminated when the tariff increases expire. Extending the proposed three-year remedy will only delay the inevitable without addressing the fundamental problem. Indeed, the Trade Policy Committee should consider whether by insulating the domestic producers from the rigors of competition, the proposed remedy may only exacerbate the long-run position of the domestic producers and workers.

Conclusion

The Trade Act of 1974 was intended to protect domestic industries from the competition of imports in certain circumstances. The legislative history of the Act provides the following illustration:

> "If the choice is between (1) allowing an industry to collapse and thereby creating greater unemployment, larger Federal or state unemployment compensation payments, reduced tax revenues, and all the other costs to the economy associated

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* ITC Report at A-13.

** ITC Report at A-18.

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February 12, 1980
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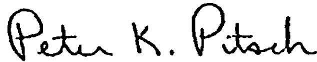
> with high unemployment, or (2) temporarily protecting that industry from excessive imports at some marginal costs to the consumer, then the Committee feels that the President should adopt the latter course and protect the industry and the jobs associated with that industry."*

As the above analysis demonstrates, the present case and the proposed remedy do not fit that example. In contrast, the present circumstances do not include a collapsing industry, high unemployment and the attendant Federal and state government costs. Furthermore, the proposed relief from imports would exact a heavy, not marginal, toll on consumers and retailers. Finally, the proposed temporary relief will not effect fundamental change but actually might generate more financial strain and unemployment.

For these reasons, Montgomery Ward strongly believes the proposed remedy is unwarranted and injurious to the national economic interest.

Yours very truly,



Peter K. Pitsch

PKP/rk

Enclosures

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* [1974] U.S. Code Cong. & Ad. News, 7263, 7269.

APPENDIX

To estimate the potential impact of a 25-point tariff increase on prices and sales, this analysis attempts to quantify the price-sales relationship of one widely sold item. In 1978-79, this item had sales of $700,000 and $620,000. (Wards total sales of men's and women's leather coats and jackets were roughly $19 million for both 1978 and 1979.) The following table gives the ticket prices and unit sales figures for 1977 through 1979:

Year	Ticket Price	Units
1977	$112.00	3256
1978	99.55	7092
1979	131.40	4735

These figures can serve as the basis for quantifying the relationship between the price and quantity demanded during 1977 to 1978 and 1978 to 1979. The most common measure of the relationship between price and quantity is price elasticity. Price elasticity can be thought of as the percentage change in the quantity demanded of a good evoked by a one per cent change in price. The following table gives the arc price elasticity for 1977 to 1978 and 1978 to 1979:*

Year	Arc Price Elasticity
1977-1978	-6.239
1978-1979	-1.445

These calculations assume that all other demand influencing variables have remained unchanged between the two years compared. Two possible exceptions in this case are taste and nominal income. However, because these three years saw significant changes in price, the price effect may predominate the income and taste changes. In any event, these calculations are intended to provide broad estimates. With that caveat in mind, arc elasticity provides a means of projecting the effect of a tariff - caused price increase on the sales of this item. Because at higher prices

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* Arc price elasticity measures the average price elasticity over some range of the demand function. The following formula gives the arc price elasticity:

$$\text{Arc Price Elasticity} = \frac{Q_2 - Q_1}{P_2 - P_1} \cdot \frac{P_2 + P_1}{Q_2 + Q_1}$$

the demand should be more inelastic, the lower elasticity will be used in the following estimates.

It is necessary first to project what effect a 25-point tariff increase will have on this item's price. Before the ITC published its Report, the ticket price was scheduled to be increased roughly 27 per cent due to material and labor increase: from \$131.40 to \$167.66. Assuming Wards prices this item to absorb the full 25-point increase, it is estimated that the average ticket price would go up approximately 60 per cent: from \$131.40 to \$210.00. To illustrate the effect of even a small tariff increase and to provide a lower limit on the potential consumer loss, all the loss estimates will be made for two ticket prices, \$185.00 and \$210.00.

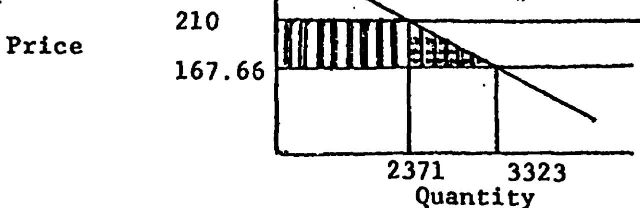
To estimate the dollar loss to consumers from possible tariff increases, unit sales are calculated for the different prices. The following table gives those results.

	1980 Price	Units (Arc Price Elasticity -1.445)	Percent Reduction in Planned Sales
Planned Price	167.66	3323	- - -
Price with medium tariff increase	185.00	2873	13.54
Price with 25-point tariff increase	210.00	2371	28.65

Without any tariff increases, the 1980 price would be \$167.66 and the 1980 quantity demanded would be 3323. With a 25-point tariff increase, however, the price is \$210 and demand is 2371.

Thus, the dollar loss to consumers equals the sum of the money paid in increased prices and the dollar value of the consumer surplus attributable to the foregone sales. The former component in this case equals (2371)(\$210-\$167.66) = \$100,388. The latter component can be approximated by taking one-half of the product of the differences in prices and quantities demanded; i.e., 1/2 (\$210-\$167.66)(3323-2371) = \$20,153.84. Therefore, the total dollar loss from the tariff equals \$100,388 plus \$20,153 or over \$120,000. A similar calculation for the smaller tariff increase gives a dollar loss of \$53,719.

The following graph illustrates both types of consumer loss:



The vertical lines indicate the additional dollars paid for the garment by those consumers who continue to buy it at the $210 price. The cross-hatched area indicates the dollar value of the consumer surplus attributable to the foregone purchases.

The estimates of potential dollar loss to consumers, $54,000 and $120,000, represent roughly 8 and 17 per cent of the $700,000 total sales for this item in 1978. If the same percentage losses apply to Montgomery Ward's $19 million in sales of leather coats and jackets, then Wards' customers would lose between 1.5 and 3.2 million dollars in 1980 alone.

The Chamber
New Orleans and the River Region

July 14, 1980

The Honorable W. Henson Moore
U. S. House of Representatives
2444 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Moore:

Thank you for your interest in securing a delay in the effective date of the Internal Revenue Service ruling on "excess" inventory. Senate Bill 2805 and its companion, House Bill 7390, both are aimed at changing the effective date to the end of this year.

The Chamber believes, however, that these bills could be amended to include language which would prevent the IRS from going beyond the narrow limits outlined in the Thor decision regarding inventory valuation methods.

The language which we propose is an addition to Section 471 of the Internal Revenue Code and would come at the end of the present wording. At present the section ends with the phrase "as most clearly reflecting the income."

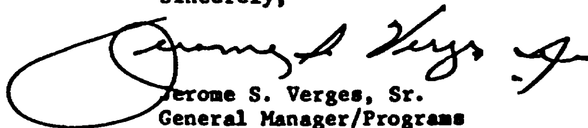
We propose that the period at the end of this phrase be replaced with a comma and the following words be added:

> "or on such other basis as conforms to generally accepted accounting practice in the particular trade or business and constitutes an inventory practice of the taxpayer consistently followed from year to year, adhered to in the first taxable year ending on or after December 25, 1979, and in the two prior taxable years."

We feel the addition of these words will stop the confusion and harm caused by the recent IRS actions growing out of the Thor decision.

Thank you for your interest in this problem.

Sincerely,



Jerome S. Verges, Sr.
General Manager/Programs

7/30/80

/dh

Statement of Thomas F. Patton and
Ralph S. Tyler, Jr. Submitted to the
Subcommittee on Taxation and Debt
Management of the Committee on Finance
United States Senate
August 27, 1980

H.R. 7171

Section 4

As the trustees of Erie Lackawanna Railway Company ("EL"), we confirm that our claims in the proceedings for valuation of the rail properties of EL which were conveyed to Consolidated Rail Corporation ("Conrail") ascribe a net liquidation value to the properties which if accepted would result in the common stock of EL having substantial value. It is therefore premature, to say the least, to hold that the common stock is worthless.

Section 5

Section 5 of H.R. 7171 covers an entirely different point. Certain railroad corporations in bankruptcy, including EL, transferred rail properties to Conrail in 1976 pursuant to orders of the Special Court established by the Regional Rail Reorganization Act of 1973. Valuation proceedings are currently before the Special Court. The award of the Special Court in the valuation proceedings will be paid in stock of Conrail and United States Railway Association ("USRA") certificates of value. EL will realize gain or loss on the disposition of these securities, but, more importantly, it appears that it will realize substantial interest income from the USRA

certificates of value, which will bear interest at 8 percent compounded annually from April 1, 1976.

Most of the railroads which transferred properties to Conrail had substantial net operating loss carryovers. In 1976, Congress enacted section 374(e) of the Internal Revenue Code to preserve these loss carryovers beyond the time they would ordinarily expire with the result that they can be used to offset any interest income on the USRA certificates of value. EL, however, is a subsidiary of DERECO, Inc., which is a subsidiary of Norfolk and Western Railway Company ("NW"). All of EL's losses have been used against consolidated income on the NW consolidated tax returns.

The losses of EL used on the consolidated returns exceeded the tax basis of the parent corporation for the EL stock. These losses in excess of tax basis will be restored to income of the parent no later than the date on which the parent loses control of EL as a result of the implementation of the plan of reorganization of EL, which is now pending in bankruptcy court.

The NW affiliated group will accordingly lose the benefit of the losses to the extent such losses were in excess of tax basis. However, even though the group will be denied the use of such losses, and EL will no longer be joining in the group's consolidated tax returns, the consolidated return regulations do not provide for restoration of the losses to the subsidiary. Therefore, unlike the other railroads which transferred their properties to Conrail, EL will have no losses from prior years to offset the interest income

expected after the amount of the award is established in the valuation proceedings.

Section 5 of H.R. 7171 would preserve the pre-1977 losses of a railroad corporation in this situation, but only to the extent the benefit of use of the losses is taken from the parent, and only to offset income received or accrued pursuant to the award. The preserved losses would be restored to the railroad corporation in an amount which corresponds to the ordinary income, or the ordinary income equivalent of capital gain (adjusted to reflect the lower capital gains rate), recognized by the parent when the losses are restored to its income.

Section 5 is in accord with the general principle of the Internal Revenue Code that a corporation which suffers an operating loss in a taxable year is permitted to use that loss to offset its taxable income for other years.

The Treasury Department has stated that it does not object to Section 5.