1981–82 MISCELLANEOUS TAX BILLS V

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 639

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 WITH RESPECT TO THE INCOME TAX TREATMENT OF INCENTIVE STOCK OPTIONS

S. 702

A BILL TO ALLOW AN INCOME TAX DEDUCTION FOR CERTAIN MOTOR CARRIER OPERATING AUTHORITIES TO OFFSET THE IMPACT OF THE MOTOR CARRIER REFORM ACT OF 1980

S. 738

A BILL TO AMEND THE INTERNAL REVENUE CODE

MAY 8, 1981

Printed for the use of the Committee on Finance

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1981-82 MISCELLANEOUS TAX BILLS V

FRIDAY, MAY 8, 1981

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

The subcommittee, met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Packwood (chairman of the subcommittee) presiding.

Present: Senators Packwood, Durenberger, and Bensten.

[The committee press release announcing this hearing; the bills S. 639, S. 702, S. 738; the description by the Joint Committee on Taxation follow:]

Press Release No. 81-125

PRESS RELEASE

FOR IMMEDIATE RELEASE
April 16, 1981

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 MISCELLANEOUS TAX BILLS

Senator Packwood, 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 May 8, 1981 on three miscellaneous tax bills.

The hearing will begin at 9:30 a.m. on May 8, 1981, in Room 2221 of the Dirksen Senate Office Building.

The following pieces of legislation will be considered at the hearing:

Incentive Stock Options

S. 639 -- Introduced by Senator Packwood for himself and Senator Bentsen. Would create a new class of stock options entitled to favorable tax treatment, including deferral of the tax ordinarily applicable on exercise of the option and the taxation of gain on the sale of option stock at capital gains rates.

Deduction of Devalued Motor Carrier Operating Rights

S. 702 -- Introduced by Senator Baucus for himself and others. Would permit the ratable deduction over 36 months beginning July 1, 1980 of the adjusted basis of motor carrier operating licenses and other rights devalued by deregulation.

St. Paul Port Authority Revenue Bonds

S. 738 -- Introduced by Senator Durenberger. Would permit certain advance refunding issues of industrial revenue bonds to qualify under section 103 of the Code. This provision is narrowly drawn and intended to benefit the Port Authority of the City of St. Paul, Minnesota.

Requests to Testify. Witnesses who desire to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on April 30, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such case a witness should notify the Committee of his inability to appear as soon as possible.

Consolidated Testimony. Senator Packwood urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. The procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain. Senator Packwood urges very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act. Senator Packwood 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) All witnesses must submit written statements of their testimony.

(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 noon on Thursday, May 7, 1981.

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

(5) Not more than five minutes will be allowed for the oral summary.

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 on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, not later than Monday, May 25, 1981. On the first page of your written statement please indicate the date and subject of the hearing.

P.R. #81-125

II

97TH CONGRESS
1ST SESSION

S. 639

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of incentive stock options.

IN THE SENATE OF THE UNITED STATES

MARCH 5 (legislative day, FEBRUARY 16), 1981

Mr. PACKWOOD (for himself and Mr. BENTSEN) introduced the following bill; which was referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of incentive stock options.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part II of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to certain stock options) is amended by adding after section 422 the following new section:

"SEC. 422A. INCENTIVE STOCK OPTIONS.

"(a) IN GENERAL.—Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option if—

"(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 1 year after the transfer of such share to him, and

"(2) at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

"(b) INCENTIVE STOCK OPTION.—For purposes of this part, the term 'incentive stock option' means an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

"(1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

"(2) such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

"(3) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;

"(4) the option price is not less than the fair market value of the stock at the time such option is granted;

"(5) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

"(6) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

Paragraph (6) shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option and such option by its terms is not exercisable after the expiration of 5 years from the date such option is granted.

"(c) SPECIAL RULES.—

"(1) EXERCISE OF OPTION WHEN PRICE IS LESS THAN VALUE OF STOCK.—If a share of stock is transferred pursuant to the exercise by an individual of an option which would fail to qualify as an incentive stock option under subsection (b) because there was a failure in an attempt, made in good faith, to meet the requirement of subsection (b)(4), the requirement of subsection (b)(4) shall be considered to have been met.

"(2) CERTAIN DISQUALIFYING DISPOSITIONS WHERE AMOUNT REALIZED IS LESS THAN VALUE AT EXERCISE.—If—

"(A) an individual who has acquired a share of stock by the exercise of an incentive stock option makes a disposition of such share within the 2-year period described in subsection (a)(1), and

"(B) such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual,

then the amount which is includible in the gross income of such individual, and the amount which is deductible from the income of his employer corporation, as compensation attributable to the exercise of such option shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share.

"(3) CERTAIN TRANSFERS BY INSOLVENT INDIVIDUALS.—If an insolvent individual holds a share of stock acquired pursuant to his exercise of an incentive stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under title 11 or any other similar insolvency proceeding, neither such transfer, nor any other transfer of such share for the benefit of his creditors in such proceeding, shall constitute a disposition of such share for purposes of subsection (a)(1).

"(4) STOCK MAY BE PAID FOR WITH EMPLOYER STOCK.—The employee may pay for the stock with money or other property (including stock of the corporation granting the option).

"(5) COORDINATION WITH SECTIONS 422 AND 424.—Sections 422 and 424 shall not apply to an incentive stock option.".

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Section 421 of such Code (relating to general rules in the case of stock options) is amended—

(A) by inserting "422A(a)," after "422(a)," in subsections (a), (b), and (c)(1)(A), and

(B) by inserting "422A(a)(1)," after "section 422(a)(1)," in subsection (b).

(2) Section 425(d) of such Code (relating to attribution of stock ownership) is amended by inserting "422A(b)(6)," after "422(b)(7),".

(3) Section 425(g) of such Code (relating to special rules) is amended by inserting "422A(a)(2)," after "422(a)(2),".

(4) Section 425(h)(3)(B) of such Code (relating to definition of modification) is amended by inserting "422A(b)(5)," after "422(b)(6),".

(5) Section 6039 of such Code (relating to information required in connection with certain options) is amended—

(A) by inserting ", an incentive stock option," after "qualified stock option" in subsection (a)(1),

(B) by inserting "incentive stock option," after "qualified stock option," in subsection (b)(1), and

(C) by adding at the end of subsection (c) the following new paragraph:

"(4) The term 'incentive stock option', see section 422A(b).".

(6) The table of sections for part II of subchapter D of chapter 1 of such Code is amended by inserting after the item relating to section 422 the following new item:

"Sec. 422A. Incentive stock options.".

SEC. 2. EFFECTIVE DATES AND TRANSITIONAL RULES.

(a) The amendments made by section 1 shall apply with respect to—

(1) options granted after December 31, 1980,

(2) qualified options (within the meaning of section 422) granted on or before December 31, 1980, which are exercised after such date, and

(3) other options granted on or before December 31, 1980, which are exercised after December 31, 1980.

Paragraph (3) shall apply to an option unless the corporation granting such option elects to have the amendments made by section 1 not apply. Such election must be made not later than 6 months after the date of enactment of this Act. Such an election, once made, may be revoked only with the consent of such Secretary or his delegate.

(b) In the case of an option granted before January 1, 1982, paragraph (1) of section 425(h) of such Code shall not apply to any change in the terms of such option made before not more than 6 months after the date of enactment of this Act to permit the plan to modify or delete a stock appreciation right or other rights to cash payments concurrent with exercise of the option.

II

97TH CONGRESS
1ST SESSION

S. 702

To allow an income tax deduction for certain motor carrier operating authorities to offset the impact of the Motor Carrier Reform Act of 1980.

IN THE SENATE OF THE UNITED STATES

MARCH 12 (legislative day, FEBRUARY 16), 1981

Mr. BAUCUS (for himself, Mr. PACKWOOD, Mr. CANNON, Mr. RIEGLE, Mr. BENTSEN, Mr. WALLOP, Mr. MATSUNAGA, and Mr. BOREN) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To allow an income tax deduction for certain motor carrier operating authorities to offset the impact of the Motor Carrier Reform Act of 1980.

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

SECTION 1. DEDUCTION FOR MOTOR CARRIER OPERATING AUTHORITY.

(a) GENERAL RULE.—For purposes of chapter 1 of the Internal Revenue Code of 1954, in computing the taxable income of a taxpayer who, on July 1, 1980, held one or more motor carrier operating authorities, an amount equal to the greater of—

(1) $50,000, or

(2) the aggregate adjusted bases of all motor carrier operating authorities held by the taxpayer on July 1, 1980, or acquired on or subsequent thereto pursuant to a binding contract in effect on such July 1, 1980, shall be allowed as a deduction ratably over a period of 36 months. Such 36-month period shall begin with the month of July, 1980, or, at the election of the taxpayer, the first month of the taxpayer's first taxable year beginning after July 1, 1980.

(b) DEFINITION OF MOTOR CARRIER OPERATING AUTHORITY.—For purposes of this section, the term "motor carrier operating authority" means a certificate or permit held by a motor common or contract carrier of property and issued pursuant to subchapter II of chapter 109 of title 49 of the United States Code.

(c) SPECIAL RULES.—

(1) CONTROLLED GROUPS.—For purposes of this section—

(A) all component members of a controlled group (within the meaning of section 179(d)(7) of the Internal Revenue Code of 1954) shall be treated as one taxpayer, and

(B) the dollar amount specified in subsection (a)(1) shall be apportioned among the component members of such controlled group in such manner as the Secretary of the Treasury (or his delegate) shall by regulations prescribe.

(2) ADJUSTED BASIS.—For purposes of the Internal Revenue Code of 1954, proper adjustments shall be made in the adjusted basis of any motor carrier operating authority held by the taxpayer on July 1, 1980, for the amounts allowable as a deduction under this section.

(d) EFFECTIVE DATE.—The provisions of this section shall apply to taxable years ending on or after July 1, 1980.

II

97TH CONGRESS
1ST SESSION

S. 738

To amend the Internal Revenue Code.

IN THE SENATE OF THE UNITED STATES

MARCH 19 (legislative day, FEBRUARY 16), 1981

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

---

A BILL

To amend the Internal Revenue Code.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to items specifically excluded from gross income) is amended by redesignating section 103(b)(8) as section 103(b)(9) and by inserting after section 103(b)(7) the following new section:

"(8) ADVANCE REFUND OF QUALIFIED ISSUES.—

"(A) IN GENERAL.—Paragraph (1) shall not apply to a refunding issue if—

"(i) the refunding issue is secured by a pledge of substantial revenues of the issuer derived from 20 or more facilities operated or leased by the issuer,

"(ii) the issuer of such refunding issue is a political subdivision engaged primarily in promoting economic development,

"(iii) the issuer of such refunding issue was created under State law at least 20 years prior to the issuance of such refunding bonds for the express purpose of promoting economic development, and

"(iv) any debt service savings derived from the refunding may be used only for the proper corporate purposes of the issuer and shall not be used to reduce any existing obligations of any person who is not an exempt person (within the meaning of paragraph (3)).".

DESCRIPTION OF TAX BILLS
(S. 639, S. 702, AND S. 738)

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on May 8, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are three bills scheduled for the hearing: S. 639 (relating to incentive stock options), S. 702 (relating to deduction for diminution in value of motor carrier operating authorities), and S. 738 (relating to advance refunding of St. Paul Port Authority revenue bonds).

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

I. SUMMARY

1. S. 639—Senators Packwood and Bentsen

Incentive Stock Options

Under present law, the value of a stock option granted by an employer to an employee is taxed, when the option is received, as ordinary income to the employee only if the option itself has a readily ascertainable fair market value. If the option does not then have a readily ascertainable value, the spread between the value of the stock received on exercise and the option price is taxed, when the option is exercised, as ordinary income to the employee. The employer generally is allowed a business expense deduction corresponding to the ordinary income taxed to the employee (Code sec. 83).

Under the bill, a compensatory stock option which meets certain requirements (called an "incentive stock option") would not result in taxation to the employee either when the option is granted or when the option is exercised. Instead, when stock received on exercise of the option is sold, the employee generally would be taxed at capital gains rates on the difference between the amount received for the stock and its basis (the option price). The employer would receive no deduction with respect to an incentive stock option.

Generally, the bill would apply to options exercised after December 31, 1980.

2. S. 702—Senators Baucus, Packwood, Cannon, Riegle, Bentsen, Wallop, Matsunaga, Boren, Symms, Durenberger, Jepsen, and Kassebaum

Deduction for Diminution in Value of Motor Carrier Operating Authorities

Under present law (Code sec. 165), a deduction is allowed for a loss incurred in a trade or business which is sustained during the taxable year and not compensated for by insurance or otherwise. In general, the amount of the deduction equals the adjusted basis of the property involved.

As a general rule, no deduction is allowed for a decline in value of property absent a sale, abandonment, or other disposition of the property. In several decisions, courts have denied a loss deduction where the value of an operating permit or license was reduced as a result of legislation expanding the number of licenses or permits which could be issued. These decisions held that the diminution in the value of a license or permit did not constitute an event giving rise to a loss deduction under Code section 165 where the license or permit continued to have value as a right to carry on a business.

The bill provides that a deduction would be allowed ratably over a 36-month period (generally, beginning July 1, 1980) for taxpayers who held motor carrier operating authorities on July 1, 1980, the date of enactment of the Motor Carrier Act of 1980. (The 1980 statute lessened restrictions existing pursuant to prior law and administrative practices on entry into interstate motor carrier business, as a result of which holders of operating authorities had been afforded protection against competition; however, an operating authority still must be obtained to conduct interstate motor carrier business.) The amount of the deduction would be the greater of $50,000 or the total adjusted basis of all motor carrier operating authorities held by the taxpayer on July 1, 1980 (or acquired after that date under a binding contract in effect on July 1, 1980).

The provisions of the bill would be effective for taxable years ending after June 30, 1980.

3. S. 738—Senator Durenberger

Advance Refunding of St. Paul Port Authority Revenue Bonds

Under present law, interest on certain industrial development bonds qualifies for tax exemption if substantially all the bond proceeds are used to provide certain "exempt activity" facilities. Interest on a refunding issue of a tax-exempt industrial development bond more than six months in advance of the retirement of the original bonds qualifies for tax exemption only if substantially all the proceeds of the refunded issue were used to provide a qualified public facility. Qualified public facilities include airports, docks, wharves, mass commuting facilities, and parking facilities (and related storage or training facilities) which are available for use by the general public (Code sec. 103(b)(7)).

Under the bill, interest on an advance refunding issue of industrial development bonds would be exempt from taxation, without regard to the present-law public use requirement, provided that: (1) the refunding issue is secured by a pledge of substantial revenues of the issuer derived from 20 or more facilities operated or leased by the issuer; (2) the refunding issuer is a political subdivision engaged primarily in promoting economic development; (3) the issuer was created under State law at least 20 years prior to the issuance of the refunding bonds for the express purpose of promoting economic development; and (4) any debt service savings derived from the refunding are to be used only for the proper corporate purposes of the issuer and not to reduce any existing obligation of a nonexempt person (i.e., any person other than a State or local government or tax-exempt organization).

The bill is intended to benefit the Port Authority of the City of St. Paul, Minnesota. The provisions of the bill would be effective on enactment.

II. DESCRIPTION OF BILLS

1. S. 639—Senators Packwood and Bentsen

Incentive Stock Options

Present law

Under present law, the taxation of stock options granted by an employer to an employee as compensation is governed by Code section 83. The value of the option constitutes ordinary income to the employee when granted only if the option itself has a readily ascertainable fair market value at that time. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at that time. Instead, when the option is exercised, the spread between the value of the stock at exercise and the option price constitutes ordinary income to the employee. Ordinary income on grant or on exercise of a stock option is treated as personal service income and hence generally taxed at a maximum rate of 50 percent.

An employer which grants a stock option generally is allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (Code sec. 83(h)).

Background of tax treatment of stock options

Restricted stock options

The Revenue Act of 1950 enacted provisions for "restricted stock options," under which neither grant nor exercise of the option gave rise to income to the employee. Instead, income generally was recognized at the time the employee sold stock which had been received pursuant to exercise of the option. No deduction was allowed to the employer matching the amount of income recognized by the employee (the gain on sale of the stock).

If the option price was at least 95 percent of the market price of the stock at the time the option was granted, the entire amount of any gain realized by the employee at the time the stock was sold was treated as capital gain. If the option price was between 85 and 95 percent of the market price at the time the option was granted, the difference between the market value of stock at the time of the option grant and the option price was treated as ordinary income when the stock was sold, and any additional gain at the time the stock was sold was treated as capital gain.

For a stock option to be classified as "restricted," the option price had to be at least 85 percent of the market price of the stock at the time the option was granted; the stock or the option had to be held by the employee for at least two years after the date of the granting of the option, and the stock held for at least six months after it was transferred to the employee; the option could not have been transferable other than at death; the individual could not have held ten percent or more of the stock of the corporation (unless the option price was at least 110 percent of the fair market value); and the option could not have been for a period of more than ten years.

Qualified stock options

The Revenue Act of 1964 repealed the restricted stock option provisions and enacted provisions for "qualified stock options." These qualified stock options generally were taxed similarly to restricted stock options.

Qualified options had to be granted with an option price of at least the stock's market price when the option was granted (subject to a 150-percent inclusion in income where a good faith attempt to meet this requirement failed). In addition, qualified stock options were subject to the requirements that the stock had to be held three years or more; the option could not be held more than five years; stockholder approval had to be obtained; the options had to be exercised in the order granted; and no option could be granted to shareholders owning more than five percent of the stock (increased up to ten percent for corporations with less that $2 million equity capital).

1969 Tax Reform Act—Minimum tax and maximum tax

The Tax Reform Act of 1969 enacted a minimum tax, under which a tax was imposed equal to ten percent of the items of tax preference (reduced by a $30,000 exemption plus regular tax liability). Both the bargain element on restricted and qualified stock options and the excluded portion of capital gains were items of tax preference.

In addition, a 50-percent maximum marginal tax rate on income from personal services was added by the 1969 Act. Income eligible for this rate was reduced generally by the sum of the items of tax preference in excess of $30,000.

1976 Tax Reform Act—Repeal of qualified stock options

The Tax Reform Act of 1976 repealed qualified stock option treatment for options granted after May 20, 1976 (except for certain transitional options which will cease to be qualified after May 20, 1981). The 1976 Act also increased the minimum tax rate to 15 percent, reduced the exemptions for the minimum and maximum tax, and permitted deferred compensation to qualify for the 50-percent maximum rate on personal service income.

Revenue Act of 1978—Treatment of capital gains

The Revenue Act of 1978 removed the excluded portion of capital gains from the minimum and maximum tax and made it subject to a new alternative minimum tax. In addition, taxes on capital gains were reduced, so that the maximum rate of tax on capital gains is 28 percent.

Issue

The principal issue is whether to reinstitute rules for tax treatment of stock options under which the employee would not recognize income on receipt of the option or exercise of the option, the employee would be taxed only at capital gains rates at the time the stock is sold, and the employer would not receive a deduction with respect to the option.

Explanation of the bill

In general

The bill would enact provisions for "incentive stock options," which would be taxed in a manner similar to the tax treatment previously applied to restricted and qualified stock options. That is, there would be no tax consequences when an incentive stock option is granted or when the option is exercised, and the employee would be taxed at capital gains rates when the stock received on exercise of the option is sold. Similarly, no business expense deduction would be allowed to the employer with respect to an incentive stock option.

The term "incentive stock option" would mean an option granted to an individual, for any reason connected with his or her employment, by the employer corporation or by a parent or subsidiary corporation of the employer corporation, to purchase stock of any of such corporations.

Requirements (holding period, etc.)

To receive incentive stock option treatment, the bill would provide that the employee must not dispose of the stock within two years after the option was granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, the tax would be imposed on sale of the stock, but gain would be treated as ordinary income rather than capital gain, and the employer would be allowed a deduction at that time.[1]

In addition, for the entire time from the date of granting the option until three months before the date of exercise, the option holder must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirements would be waived in the case of the death of the employee.[2]

Terms of option

For an option to qualify as an "incentive stock option," the bill would provide that the terms of the option itself would have to meet the following conditions:

1. The option must be granted under a plan specifying the number of shares of stock to be issued and the employees or class of employees to receive the options. This plan must be approved by the stockholders of the corporation within 12 months before or after the plan is adopted.

2. The option must be granted within ten years of the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.

3. The opinion must by its terms be exercisable only within ten years of the date it is granted.

4. The option price must equal or exceed the fair market value of the stock at the time the option is granted. This requirement would be deemed satisfied if there had been a good faith attempt to value

[1] In the case of a sale which does not meet the holding period requirements, the amount of ordinary income, and the amount of the employer's deduction, would be limited to the difference between the amount realized on the sale and the option price.

[2] For purposes of the holding period requirements, the bill also would provide that certain transfers by an insolvent individual of stock received pursuant to exercise of an incentive stock option are not to be treated as dispositions of such stock. The transfers which would be covered by this rule are transfers to a trustee, receiver, or similar fiduciary, or other transfers for the benefit of the individual's creditors, in a bankruptcy case or similar insolvency proceeding.

the stock accurately, even if the option price was less than the stock value.

5. The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

6. The employee must not, immediately before the option is granted, own stock representing more than ten percent of the voting power or value of all classes of stock of the employer corporation or its parent or subsidiary.[8] However, the stock ownership limitation would be waived if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.

Other rules

The bill would provide that stock acquired on exercise of the option could be paid for with stock of the corporation granting the option.

The difference between the option price and the fair market value of the stock at the exercise of the option would not be an item of tax preference.

Also under the bill, any option which is a qualified stock option or restricted stock option under present law would become an incentive stock option if it was not exercised before January 1, 1981, and if it otherwise satisfies requirements for incentive stock options.

Effective date

The bill generally would apply to options exercised after December 31, 1980. However, in the case of an option which was granted on or before December 31, 1980 and which was not a qualified option, the corporation granting the option could elect (within six months after enactment of the bill) to have the option not treated as an incentive stock option.

In the case of an option granted before 1982, the modification or deletion of any stock appreciation right or right to receive cash payments to permit the option to qualify as an incentive stock option could be made within six months of the enactment of the bill without the modification being treated as the grant of a new option.

Revenue effect

It is estimated that the bill would reduce budget receipts by a negligible amount in fiscal year 1981 and by less than $5 million annually in fiscal years 1982 through 1984. It is further estimated that this bill would increase budget receipts by $15 million in fiscal year 1985 and by $30 million in fiscal year 1986.

Prior Congressional action

In the 96th Congress, the Senate Finance Committee reported a bill (H.R. 5829, sec. 224) including substantially identical provisions for incentive stock options (Sen. Rpt. 96-940). No further action was taken on that bill.

[8] For this purpose, the individual would be considered to own stock owned directly or indirectly by brothers and sisters, spouse, ancestors, and lineal descendants, and stock owned directly or indirectly by a corporation, partnership, estate, or trust would be considered as being owned proportionately by shareholders, partners, or beneficiaries.

2. S. 702—Senators Baucus, Packwood, Cannon, Riegle, Bentsen, Wallop, Matsunaga, Boren, Symms, Durenberger, Jepsen, and Kassebaum

Deduction for Diminution in Value of Motor Carrier Operating Authorities

Present law

Background

Enacted in 1935, Part II of the Interstate Commerce Act (the "1935 Act") provided the basic framework for regulation of the motor carrier industry until enactment of the Motor Carrier Act of 1980. Under the 1935 Act, carriers were obligated to provide nondiscriminatory service at regulated rates for the public convenience and necessity, and further industry regulation was effected by issuing or withholding certificates of operating authority.

During the period 1935 to 1980, the Interstate Commerce Commission ("ICC") granted a limited number of permits and certificates of operating authority to motor carriers and freight forwarders. The basis for the grant of an authority from the ICC was a showing that additional service of the type for which authority was sought was or would be required by the public convenience and necessity. Businesses with existing operating rights could intervene in a proceeding for a request of operating authority to show that the proposed service was not or would not be required by the public convenience and necessity.

The right of existing operators to intervene (based on ICC procedural rules) and the applicant's burden of showing that the proposed service was required by the public convenience and necessity (based on the 1935 Act) gave existing operators protection against competition. Persons wishing to either enter the motor carrier business or expand an existing business therefore often would purchase an existing business with its operating authority.

Substantial amounts were paid for these operating authorities, reflecting, in part, the protection against competition afforded to authority owners under ICC administration of the 1935 Act. The value of the operating authorities provided owners with an asset that constituted a substantial part of a carrier's asset structure (sometimes amounting to over 50 percent of a concern's assets) and a source of loan collateral.

In 1975, the ICC began to grant a higher percentage of requests for operating authorities under the standard of "required by the public convenience and necessity." On July 1, 1980, the Motor Carrier Act of 1980 was enacted (P.L. 96-296). Under the 1980 Act, applicants do not need to show that the proposed service is required by the public convenience and necessity. Existing operators protesting the grant of an authority bear the burden of showing the proposed service is inconsistent with that standard. Thus, the 1980 statute further lessened restrictions existing pursuant to prior law and administraive practices on entry into interstate motor carrier business. However, an operating authority still must be obtained in order to conduct interstate motor carrier business.

The ICC, following an opinion of the Financial Accounting Standards Board, has required that the value assigned to certificates of authority in the regulated books of motor carriers be written off in one year.

Deduction for realized loss of property

Section 165 of the Code allows a deduction for certain losses, including any loss incurred in a trade or business which is sustained during the taxable year and not compensated for by insurance or otherwise. In general, the amount of the deduction equals the adjusted basis of the property involved (Code sec. 165(b)).

Treasury regulations provide that to be allowable as a deduction, the loss must be realized, i.e., "evidenced by closed and completed transactions, fixed by identifiable events" (Reg. § 1.165-1(b)). As a general rule, no deduction is allowed for a decline in value of property absent a sale, abandonment, or other disposition of the property [1] nor for loss of anticipated income or profits.[2] Thus, in order for a loss to be allowed under present law, generally either the business must be discontinued or the property must be abandoned or permanently discarded from use in the business (Reg. § 1.165-2). Generally, if a capital asset declines in value and is sold or exchanged at a loss, the loss is a capital loss, the deduction of which is subject to the limitations of Code sections 1211-1212 (Code sec. 165(f)).

The courts in several decisions [3] have denied a loss deduction where the value of an operating permit or license decreased as a result of legislation expanding the number of licenses or permits which could be issued. These decisions held that the diminution in the value of a license or permit did not constitute an event giving rise to a loss deduction under Code section 165 where the license or permit continued to have value as a right to carry on a business.

In the *Consolidated Freight Lines* case,[4] the Ninth Circuit denied deductions for lost "monopoly rights" when the State of Washington deregulated the intrastate motor carrier industry by eliminating restrictions on entry. The court reasoned that the taxpayer had not lost any rights conferred by the certificate of operating authority because the taxpayer was still permitted to do business and the operating

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[1] See, e.g., *Reporter Publishing Co., Inc.* v. *Comm'r*, 201 F. 2d 743 (10th Cir.), cert. den., 345 U.S. 993 (1953) (no deduction allowed to newspaper for decline in value of its membership in Associated Press after exclusivity feature held to violate antitrust laws); *Monroe W. Beatty*, 46 T.C. 835 (1966) (no deduction allowed for diminution in a value of liquor license resulting from amendment of State law limiting grant of such licenses).

[2] See, e.g., *Alsop* v. *Comm'r*, 290 F. 2d 726 (2d Cir. 1961); *Marks* v. *Comm'r*, 390 F. 2d 598 (9th Cir.), cert. den., 393 U.S. 883 (1968) (no loss deduction for difference between actual earnings and what taxpayer's earnings would have been absent revocation of her teaching credentials).

[3] *Consolidated Freight Lines, Inc.* v. *Comm'r*, 37 B.T.A. 576 (1938), aff'd, 101 F. 2d 813 (9th Cir.), cert. den., 308 U.S. 562 (1939); *Monroe W. Beatty*, *supra* note 1.

[4] Note 3, *supra*.

authority had not given any further rights. Any "monopoly rights," the court stated, resulted from legislation and State administration restricting the availability of operating authorities. Since the taxpayer could not own (or purchase) property rights in legislation or regulations, repeal or modification of legislation or regulations did not give rise to a deductible loss, even if such action had the result of making the taxpayer's business property less valuable.

Issues

The principal issue is whether a taxpayer should be allowed a deduction on account of diminution in value of its business resulting from the Federal deregulation of any industry. A second issue is whether such a deduction should be a deduction for an ordinary loss or a capital loss.

If such a deduction is to be provided to motor carrier operators, other issues include whether the amount of the deduction should be limited to the taxpayer's adjusted basis (either in the certificate of operating authority or in its motor carrier business as a whole), and whether there should be an additional limit based on the actual loss of fair market value (either the value of the certificate or of the business as a whole) resulting from deregulation. Another issue is whether motor carrier businesses which held and benefited from certificates for a period of time before deregulation should be given the same tax relief as businesses which acquired their certificates shortly before deregulation.

Explanation of the bill

The bill provides that an ordinary deduction would be allowed ratably over a 36-month period for taxpayers who held one or more motor carrier operating authorities on July 1, 1980. The amount of the deduction would be the greater of $50,000 or the total adjusted bases of all motor carrier operating authorities either held by the taxpayer on July 1, 1980 or acquired after that date under a binding contract in effect on July 1, 1980. (The minimum deduction of $50,000 would be available even if that amount exceeds the operator's investment in its operating rights or exceeds the value of such rights.) The 36-month period would begin July 1, 1980 (or at the taxpayer's election, with the first month of the taxpayer's first taxable year beginning after July 1, 1980).

Under the bill, adjustments would be made to the bases of operating authorities held on July 1, 1980 (or acquired thereafter under a binding contract in effect on July 1, 1980) to reflect amounts that would be allowable as deductions under the bill.[5]

The bill also would provide special rules relating to component members of a controlled group of corporations. Under the bill, the controlled group would be treated as a single taxpayer. If the deduction of $50,000 is allowed (exceeding the total adjusted bases of operating authorities held by the group on July 1, 1980), the deduction

[5] The bill would not provide whether adjustments would be made to the bases of other property of the taxpayer if the deduction allowable under the bill exceeds the taxpayer's adjusted bases in operating authorities. This situation could arise under the bill if the adjusted bases of operating authorities are less than the alternative $50,000 deduction.

would be apportioned among the component members in accordance with Treasury regulations.

Effective date

The provisions of the bill would be effective for taxable years ending after June 30, 1980.

Revenue effect

It is estimated that the bill would reduce budget receipts by $40 million in fiscal year 1981, $291 million in 1982, $143 million in 1983, and $55 million in 1984.

3. S. 738—Senator Durenberger

Advance Refunding of St. Paul Port Authority Revenue Bonds

Present law

Industrial development bonds—In general

In general, interest on State and local government bonds is exempt from Federal income tax (Code sec. 103(a)). However, with certain exceptions, this exemption does not apply to interest on State and local government issues of "industrial development bonds." An obligation constitutes an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property, or borrowed money, used in a trade or business (sec. 103(b)(2)).

Under one exception to the general rule of taxability of interest on industrial development bonds, the exemption applies to such bonds if the proceeds are used to provide facilities for certain exempt activities. Such exempt activity facilities include convention and trade show facilities (sec. 103(b)(4)(C)) and airports, docks, wharves, mass commuting facilities, parking facilities, and storage or training facilities directly related to any of the foregoing (sec. 103(b)(4)(D)).

In general, in order to qualify as an exempt activity facility, the facility must satisfy a public use requirement; that is, it must serve or be available on a regular basis for general public use or be part of a facility so used (Treas. Reg. § 1.103–8(a)(2)). Transportation facilities in general satisfy the public use requirement if available for use by members of the general public or by common carriers or charter carriers which serve members of the general public (Treas. Reg. § 1.103–8(e)(1)). Also, a dock or wharf which is part of a public port satisfies the public use requirement (Treas. Reg. § 1.103–8(e)(1)). Convention and trade show facilities in general satisfy the public use requirement if available for an appropriate charge or rental for use by members of the general public. However, such facilities do not satisfy the public use test if use is limited by long-term leases to a single user or group of users (Treas. Reg. § 1.103–8(d)(1)).

Refunding bond issues

Present law restricts the availability of Federal income tax exemption with respect to "refunding issues" of those industrial development bonds which themselves qualify for interest exemption. In general, refunding issues are bonds from which the proceeds are used to redeem outstanding bonds. Refunding issues are issued typically to take advantage of lower current interest rates, or to remove restrictive covenants in the original bond issue.

Advance refunding issues are bonds issued more than six months prior to the retirement of the original bonds. In an advance refunding, both the original issue and the refunding issue remain outstanding.

In general, interest on an advance refunding issue of an industrial development bond is tax-exempt only if substantially all the proceeds of the refunded issue were used to provide a qualified public facility (Code sec. 103(b)(7)). Qualified public facilities, for this purpose, are (1) convention and trade show facilities and (2) airports, docks, wharves, and mass commuting facilities (and storage or training facilities directly related thereto) which are generally available to the general public.

Facilities that qualify as exempt activity facilities because they are available for use by common carriers or by charter carriers that serve members of the general public are not considered to be qualified public facilities for purposes of Code sec. 103(b)(7) unless those facilities directly serve the general public or are available on a regular basis for general public use. Also, facilities that are part of a qualified public facility are not considered to be qualified public facilities unless they also directly serve the general public or are available on a regular basis for general public use.

For example, a repair facility located in a public port that is owned by a nonexempt person, or leased to or assigned to a nonexempt person permanently or for the major portion of its useful life, does not meet the availability test if the facility does not provide services to the general public (e.g., repair services for all boats) or is not available on a regular basis for general public use. However, a facility that is owned by a governmental unit is considered to be available to the general public if it is leased to or assigned to a nonexempt person on a short-term basis, provided that the facility is available to the general public for a major portion of its useful life.

Issue

The issue is whether certain present law restrictions (relating to the public-use requirement) on advance refunding of industrial development bonds should apply in the case of the proposed advance refunding of revenue bonds issued by the Port Authority of the City of St. Paul, Minnesota, as well as whether those restrictions should apply in the case of any other issuer which could meet the requirements set forth in the bill.

Explanation of the bill

Under the bill, interest on a refunding issue of industrial development bonds would be exempt from Federal income taxation, without regard to whether the proceeds of the refunded issue were used to provide a qualified public facility, if certain requirements are met.

These requirements would be that: (1) the refunding issue is secured by a pledge of substantial revenues of the issuer derived from 20 or more facilities operated or leased by the issuer; (2) the refunding issuer is a political subdivision engaged primarily in promoting economic development; (3) the issuer was created under State law at least 20 years prior to the issuance of the refunding bonds for the express purpose of promoting economic development; and (4) any debt service savings derived from the refunding are to be used only for the proper corporate purposes of the issuer and not to reduce any existing obligation of a nonexempt person (i.e., any person other than a State or local government or tax-exempt organization).

The intended beneficiary of the bill would be the Port Authority of the City of St. Paul, Minnesota. The Port Authority's revenue bonds are secured by a pledge of substantially all of its revenues derived from facilities owned by the Port Authority but leased to private companies. The Port Authority desires to refund its prior issues in order to relieve itself of restrictive covenants no longer required by existing market conditions and to reduce the debt service on its obligations. The bill would also benefit any other issuer that meets the requirements specified in the bill.

Effective date

The provisions of the bill would be effective on enactment.

Revenue effect

If the only beneficiary of the bill would be the Port Authority of the City of St. Paul, it is estimated that the bill would reduce budget receipts by $3 million in fiscal year 1982 and by $6 million annually in fiscal years 1983 through 1986. If other issuers also could meet the requirements of the bill, as introduced, the estimated reduction of budget receipts would be substantially greater.

Senator PACKWOOD. The committee will come to order and we will start on S. 702, providing a deduction for motor carrier operator rights.

As most of you are aware, motor carrier certificates used to have a great value. But, when we deregulated the trucking industry, their value substantially diminished.

This bill addresses itself to that particular issue. The principal sponsor of it is Senator Max Baucus of Montana.

Max, are you ready?

Senator BAUCUS. Yes.

Senator PACKWOOD. OK.

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

Senator BAUCUS. Thank you, Mr. Chairman. I appreciate very much your cosponsorship of S. 702, the bill under discussion here, and your willingness to conduct early hearings.

I am also pleased to have the bipartisan support of many members of this committee, and others not on this committee.

Mr. Chairman, as you know, the Motor Carrier Act of 1980 substantially changed the 45-year-old Federal rules for motor carriers.

At the time we passed that legislation under the able bipartisan leadership of Senator Cannon and yourself, we recognized that subsequent congressional action would be required to respond to any difficulties that might arise.

Specifically, we knew that the bill might wipe out the value of operating rights held by numerous regulated carriers.

A House report on the Motor Carrier Act made that clear when it stated, "Should it become apparent that the effect of this legislation has been to substantially erode the value of operating rights, then appropriate relief of such results should be considered as early as possible."

Essentially, Mr. Chairman, this bill is designed to address that problem. It is clear that those operating rights have become substantially worthless. In fact, I have received a letter from Citibank of New York so stating. I would like to include that letter in the record, with the committee's permission.

The bill essentially permits an income deduction for 3 years for the adjusted basis of carrier's operating rights or $50,000, whichever is greater. The $50,000 floor is designed to insure that the smaller motor carriers, who are among those most threatened by the Motor Carrier Act, receive a significant tax benefit. It is important that the 3-year ratable period be retained in the bill. As, you know, Mr. Chairman, the Financial Accounting Standards Board recommends a 1-year deduction.

On the other hand, some might suggest that it should be more than 3 years. Three years, essentially, is a compromise to reduce the budgetary impact of the deduction. I suggest 3 years because, if it is more than 3 years, the effect of the deduction becomes more worthless over the longer period of time.

That, essentially, is my statement, Mr. Chairman. I thank you for the early and expeditious manner in which you have handled this hearing.

Senator PACKWOOD. Well, Max, thank you for taking the lead on this because it is very clear, we have taken away a property right without compensation in essence by the trucking deregulation act. I hope that we can attach this to the tax bill or if there are going to be two tax bills, to the second tax bill as it goes through.

Senator BAUCUS. Thank you very much, Mr. Chairman.

[Statement of Senator Baucus and a letter from Citibank follows:]

STATEMENT BY SENATOR MAX BAUCUS

Mr. Chairman, I appreciate very much your co-sponsorship of S. 702 and your willingness to conduct early hearings on it. I am also pleased to have the bipartisan support of the other Finance Committee members—Senators Wallop, Chafee, Symms, Bentsen, Matsunaga, Boren and Durenberger—and others not on the Committee.

I am confident that, with your valuable assistance, we can advance this legislation that is so important to the motor carrier industry.

Mr. Chairman, as you know, the Motor Carrier Act of 1980 substantially changed the 45 year old federal rules for motor carriers. At the time we passed that legislation, under the able bipartisan leadership of Senator Cannon and yourself, we recognized that subsequent Congressional action would be required to respond to any difficulties that might arise.

Specifically, we knew that the bill might wipe out the value of operating rights held by numerous regulated carriers. The House report on the Motor Carrier Act made clear what everyone suspected when it stated:

"Should it become apparent that the effect of this legislation has been to substantially erode the value of operating rights, then appropriate relief for such results should be considered as early as possible."

I believe it is now clear that this has occurred. I recently received a letter from Citibank of New York stating that the bank now views motor carrier operating rights as "substantially worthless."

Citibank futher notes that this erosion of assets is reflected in the bank's decision whether to grant credit. I am submitting the letter for inclusion in the hearing record.

It is clear that the new rules of the Motor Carrier Act have devalued motor carrier operating authorities.

The only equitable solution, it seems to me, is to recognize this adverse effect of the law and permit the motor carriers to deduct the value of their operating authorities.

As drafted, S. 702 permits carriers an income deducted over three years for the adjusted basis of their operating rights, or $50,000, whichever is greater.

The $50,000 floor is designed to insure that the smaller motor carriers are among those most threatened by the Motor Carrier Act.

Under standard accounting practices prescribed by the Finanical Accounting Standards Board, such a deduction would ordinarily be taken in a one year period. We have provided that the deduction is ratable over three years to reduce the budgetary impact of the bill.

Mr. Chairman, the alternative to this legislation could well be a long period of undertainty and unnecessary litigation. I hope we can avoid that prospect by moving this legislation at an early date. Thanks again for your cooperation and leadership on this issue.

NEW YORK, N.Y., *March 30, 1981.*

Re Senate bill 702.

Hon. MAX BAUCUS,
Senate Office Building,
Washington, D.C.

DEAR SENATOR: We are pleased to submit our comments and views regarding the impact of The Motor Carrier Regulatory Reform Act of 1980 on the value of motor carrier operating rights. As a major lender to the trucking industry for the past 20 years, Citibank has followed closely those developments which have had a direct bearing on the economic status of the carriers. In our opinion, the July 1 passage of the deregulation bill marks a watershed date for the industry, particularly as it affects the interrelationship between intramodal competition and operating authorities.

Historically, government regulation of the motor carriers was premised on the need to achieve industry stability in order to provide adequate service to the shipping public. As the industry matured, regulatory perceptions also changed. The Interstate Commerce Commission epitomized the new direction, with its philosophical shift towards promoting greater competition among the carriers. During the past several years this policy was evidenced by a dramatic liberalization in the Commission's grants of and application standards for new operating rights, a trend which already diluted the value of existing authorities. The Motor Carrier Act has gone beyond such administrative initiatives by providing legislative endorsement of the Commission's "de facto" deregulation efforts and by enlarging the scope of the provisions.

In light of the foregoing developments our views on the worth of operating rights have undergone a similar conversion. Heretofore, in evaluating the credit-worthinesss of trucking companies Citibank has recognized the inherent value of existing authorities. Specifically, in measuring a carrier's net worth we have not treated existing rights as intangible assets to be deducted from the equity account, provided the company historically earned a profit on these rights. However, we excluded newly-acquired authorities until the carrier demonstrated the ability to generate earnings from this authority. It should also be noted that, as a lending policy, Citibank traditionally has not made loans based on the theoretical value of a company's rights. Although we have financed the purchase of operating rights, contrary to many other banks' views, we have always regarded the use of authorities as loan collateral to be an indication of financial distress.

While Citibank has not made a practice of viewing operating rights as collateral per se, we have considered their value as a cushion for our traditional revenue equipment financing. Our inability to precisely quantify the market value of these assets, other then by applying various subjective measures, in part explains our Bank's reluctance to view authorities as a "bankable" asset. Nevertheless, until the advent of deregulation in the late 1970's operating rights had a number of underlying characteristics to which we could ascribe definite value: (i) empirical observation indicated they had undergone tremendous appreciation over time; (ii) they were readily marketable, even in distress situations; and (iii) there was an active market for existing rights among trucking companies. Given these favorable qualities, Citibank over the years was willing to advance a relatively higher proportion of funds to the carriers than would otherwise have been the case. This accommodation became evident in the form of a more liberal borrowing base ratio, which is the lending formula used in equipment financing. The rationale for increasing the borrowing base ratio in our credit agreements reflected our belief that rights afforded significant, "hidden" asset protection.

The recent actions taken by the Commission and, more particularly, by Congress, as mentioned earlier, have lowered the barriers to entry and expansion in the trucking industry. Consequently, in our opinion the practical effect of these events has been to substantially eliminate the benefits and values previously associated with a carrier's rights. The resulting era of increased competition means that the carriers will no longer be able to enjoy the protection afforded by a relatively unique set of authorities. Instead, only the well-managed carriers, which demonstrate an ability to earn a reasonable rate of return under the new and changing environment, will be able to command a premium for their company.

The implications for the financial community are equally serious. By rendering motor carrier operating rights virtually worthless, the deregulation bill forces lenders to reassess their credit granting criteria with respect to the trucking industry. It, for example, no longer can be safely assumed that a carrier's rights could be sold or liquidated to help meet any operating cash shortfalls or provide funds for debt amortization. Simply stated, there are now fewer assets available to cover existing downside risks. This represents an abrupt departure from the asset protection heretofore available and will undoubtedly lead to greater selectivity on the part of lenders in extending credit.

Over the long-run Citibank firmly believes that business as a whole is better off with less government regulation. The views expressed above, however, are not intended to make a statement regarding the merits, pro and con, of The Motor Carrier Act. Instead, they focus on the narrow issue of whether operating rights have sustained a loss in value due to the enactment of the recent legislation. As such, we would be pleased to have this letter inserted in the record and used in connection with the upcoming hearings.

Very truly yours,

MICHAEL S. FRADKIN,
Vice President.

Senator PACKWOOD. Thank you, Max.

Now, we have a panel consisting of Marvin Lourie, Roger Burbage, and Laurence Pierce.

Gentlemen, I might say, for the audience, in terms of timing, I would assume that the total hearings would be done by 11:30 today. It might be sooner than that unless we are interrupted by votes. We should be done with this bill when this panel is done and I would expect to be done with the stock option bill by 10:30 or 10:45.

In many cases, these bills are not controversial before the Finance Committee. However, the argument is often raised if we attempt to put these bills on a tax bill and they have had no hearings at all, that we are trying to railroad something through that has had no hearing. This gives us a chance to have a record. If anybody wants to know if we had a hearing, yes. There is a record.

Many of these provisions, especially the stock option provision, we have passed before. I think we will have no difficulty passing it again and we will have a record.

Gentlemen, go ahead. Who is going to testify first? Mr. Lourie? Do I pronounce it right?

STATEMENTS OF MR. MARVIN A. LOURIE, EXECUTIVE VICE PRESIDENT, RENTAR INDUSTRIES, BURBANK, ILL.; MR. ROGER BURBAGE, VICE PRESIDENT, FINANCE AND ADMINISTRATION, O'BOYLE TANK LINES AND MR. LAURENCE A. PIERCE, VICE PRESIDENT, FIRST NATIONAL BANK OF BOSTON

Mr. LOURIE. That is fine.

Thank you, Mr. Chairman and members of the committee, for the opportunity to appear before you concerning Senator Baucus' bill S. 702. I request that my full written statement, as well as my remarks today, be included in the record.

Senator PACKWOOD. All of the written statements of all of the witnesses will appear in full in the record.

Mr. LOURIE. My name is Marvin Lourie. I am executive vice president of Rentar Industries in Burbank, Ill. My company is the Nation's largest privately owned trucking distribution system of meat and processed food. We operate in 48 States and last year had gross transportation revenues of $162,500,000.

I strongly support S. 702 and urge positive and rapid action on this legislation which is so critical to the financial stability of our industry.

We, like many other motor carriers of our size, are in a worsening financial position due to the enactment of the Motor Carrier Reform Act of 1980.

Before deregulation we at Rentar Industries had on our books, operating certificates at a book value of $2.8 million and an appraised value of $26 million.

These were very real assets to the company. They were included in the value of our enterprise and were used as collateral for borrowing and were generally similar to franchise or license values in other industries.

Unlike the large publicly owned companies that utilize public equity funds to finance capital costs, we are dependent on banks and equipment manufacturer loans for such financing.

With high interest rates, it is difficult for us to borrow necessary funds to capital costs and the loss of $2.8 million in operating rights which were accepted by banks as collateral for loans, has seriously affected our ability to do business.

Rentar follows a particular economic cycle which involves a 2- to 4-year period of profitable operation, followed by a 2- to 4-year period of unprofitable operation. We have just entered into that period of unprofitable operation. Many other motor carriers are also entering this unprofitable period and are in serious financial trouble.

With this legislation, we would receive a refund of $355,632 over the 3-year period because of the ordinary loss deduction. This ordinary loss deduction will allow Rentar to continue to operate with financial stability.

The real value of the operating rights will not be replaced, but this deduction can stabilize our situation.

These were real assets. For instance, in 1962, Rentar purchased on an operating certificate from a bankrupt carrier for $213,000. In 1965, we purchased a trucking company for the price of $690,000; $514,796 of that price applied to the purchase of operating certificates.

Also, in 1969 we purchased operating certificates from a company for $500,000. These purchases, and a number of other purchases, were accomplished at the behest of our shippers or as a means reducing transportation costs.

As an example, the purchase of the operating rights for $213,000 was a direct result of the movement of the meat packing houses, such as Wilson and Montford Packing to Colorado.

While we were able to secure rights from the Interstate Commerce Commission from Colorado to points in the Midwest and the East, with the support of the shippers, we could not obtain westbound rights.

Without such rights, the cost of transporting meat would reflect the empty westbound mileage. By purchasing rights from another carrier and transporting commodities westbound the costs of shipper and in turn, to the consuming public, was lowered.

The last two acquisitions were made at the collective request of Charles Viser & Co., Peter-Paul Candy Co., Beechnut Foods, and Lifesavers, among others.

These assets, acquired to serve the shipping public and the consumers of food products, have been eliminated by the Motor Carrier Reform Act of 1980.

This legislation can stabilize the situation. I encourage your support of this legislation.

Thank you, Mr. Chairman.

Senator Packwood. Let me ask you just one question before the next witness testifies.

Why is your business so cyclical? How do you know it is going to be 2 to 4 years of profit and then 2 to 4 years of unprofitability?

Mr. Lourie. Just following the historic figures of our company, that cycle has run like that now, since about 1940—2 to 4 years, 2 to 4 years.

We could tell—we really could tell at the end of 1979 that we had hit a peak and sure enough, 1980 declined, 1981 is declining further.

Senator PACKWOOD. That is interesting. It has nothing to with the kinds of products you haul or is in no way related to bad weather and dairy and meat crops and products?

Mr. LOURIE. Well, certainly it has something to do with the meat cycle. For instance today people, for some reason, have stopped eating as much meat as they had in the past. Movement of meat from the meat producing area has dropped off substantially.

Now, whether this is the cycle that causes our profitability and our losses or not, I am not certain, but they sure are there.

Senator PACKWOOD. Thank you.

Mr. Burbage.

Mr. BURBAGE. Thank you, Mr. Chairman and members of the committee for the opportunity to appear concerning a tax matter of grave importance to the regulated motor carrier industry.

I request that my full written statement, as well as my remarks today be included in the record.

Senator PACKWOOD. They will be.

Mr. BURBAGE. My name is Roger Burbage. I am vice president, Finance and Administration, O'Boyle Tank Lines in Rockville, Md. I appear here, today, on behalf of the American Trucking Association, the National Federation of Motor Carriers having affiliated associations in every State and in the District of Columbia.

The regulated motor carrier industry is composed of over 17,000 firms, 13,000 of which have gross revenues of less than one-half of a million dollars annually.

Our industry directly employs over 600,000 persons. Total revenues for 1979 were over $40 billion.

The Motor Carrier Act of 1980, which became effective July 1, has made substantial changes in the industry. Of importance here, the value of our operating rights which were previously acquired, usually at significant expense, were rendered virtually worthless thereby threatening the financial stability of the motor carrier industry.

As was suggested by Congress when the act was passed, equity demands a legislative solution to our problem.

Today, we are asking for tax relief due to the effect of the 1980 legislation on motor carrier's operating rights. Specifically, we are supporting H.R. 1964, introduced by Congressman Holland of South Carolina and S. 702, introduced by Senator Baucus of Montana.

In 1935, Congress established a set of rules of the game for the motor carrier industry. For 45 years these rules provided for stringent entry controls into the business.

In accordance with these rules, trucking firms made substantial capital investment by purchase or otherwise to obtain these necessary operating rights.

The 1980 Motor Carrier Act, although not totally deregulating motor carrier operations, significantly changed the rules by providing far easier entry into the business. Likewise, existing motor carriers were permitted to greatly expand their operating authority.

The result of the reduction in the value of operating rights has been the impairment of capital formation in the industry by potentially jeopardizing current loans, making additional borrowing more difficult, and diminishing access to equity capital.

Mr. Chairman, a decrease in value is clearly demonstrable. A 1979 ICC study indicates that the operating rights were reflected on the balance sheets as intangible assets and were a very real asset to the carrier.

These rights were included in the value of an enterprise and were used as collateral for borrowing. Today, however, these rights have lost their value since trucking companies need simply go through the eased application procedures at the ICC to obtain rights identical to those that were purchased or otherwise obtained at great expense prior to July 1980.

Financial publications, such as Value Line, have recognized the severe reduction in the value for operating rights. In fact, the accounting profession and the ICC have required an immediate 1-year writeoff for book purposes.

The report accompanying the 1980 act recognized that the new legislation might result in a severe reduction in the value of operating rights and that appropriate tax relief might be needed.

Mr. Chairman, there is an immediate need for the tax relief discussed at the time Congress passed the 1980 act to prevent inequitable and severe competitive impact on existing motor carriers.

For example, one trucking company has total assets of about $46 million, of which $18 million are investments in operating rights, largely debt financed. As a result of the new act, the intangible asset represented by operating authority became worthless and total assets dropped over one-third to $28 million.

A new entrant into the business, today, with tangible assets of, say, $35 million without debt financed operating rights, would be able to effectively compete against the old company and drive it out of business. This is all because the rules adopted and encouraged by the U.S. Government for over 45 years were changed overnight.

This is not the free market enterprise envisioned by those who voted for the Motor Carrier Act of 1980.

Mr. Chairman, under current law it is arguable that a deduction is already available in these cases. We are proposing an ordinary deduction for the effect of the 1980 legislation on operating rights to preclude costly and time consuming litigation to determine that a deduction is present.

The legislative process provides the most reasoned approach for our industry, the public, and sound fiscal policy.

There is ample precedent for such a legislative solution. Congress has often recognized that severe economic hardships can result when the U.S. Government changes the rules of the game after taxpayers have expended substantial resources in reliance upon the old rules.

In such situations, Congress has provided appropriate tax relief. For example, special rate provisions concerning changes in policy by the Federal Communications Commission, distributions in obedience to orders of the FCC and persons impacted by the bank holding company legislation.

In summary, Mr. Chairman, the 1980 Motor Carrier Act substantially reduces the value of motor carrier operating rights. Congress anticipated this effect and has already indicated that legislative tax relief may be appropriate.

In recognition of this and out of a sense of fair play, it is equitable to allow an ordinary deduction for these rights. This deduction is crucial to the financial stability and capital formation capability of this vital American industry.

I apologize for running over.

Senator PACKWOOD. Thank you. It is a good statement. The entire statement will be in the record. I might, say, as the principal cosponsor of the trucking deregulation act I am intimately aware of this problem. We knew about it when we passed it. It was clear in testimony before the Commerce Committee at the time we passed it, in what we were doing to the value of the rights.

Mr. Pierce.

Mr. PIERCE. Thank you, Mr. Chairman, for the opportunity to be here and to have the statement of the First National Bank of Boston included in the record.

I am Laurence A. Pierce, vice president of the bank and in charge of the motor carrier segment of our bank lending activity.

The bank, by way of background, is one of the leaders in lending to the motor carrier industry. It has been agent and lead bank in syndicating credits over 25 years, has been an innovator in putting together unusual financing programs for the motor carrier industry and has authored over the years on 7 different occasions the bankers analysis of the motor carrier industry.

In order to assume such a position of responsibility in the motor carrier lending field, we determined at the outset that we should learn as much as possible about the financial characteristics of the industry that we viewed as a target for new business.

We understood the essential nature of the service provided by motor carriers to the general public and recognized immediately the public utility concept embodied in the grant of operating authorities for the public convenience and necessity.

On the other hand, we also realized, through financial analysis, that the motor carrier industry of the late 1950's and early 1960's was relatively highly leveraged with respect to the traditional relationship between debt and equity.

Our analytical efforts, we might add, were aided by our willingness to work on the banker's analysis on several different occasions.

Our initial conclusions which proved valid for at least 20 years, encouraged us to become aggressive lenders to a fledging industry, to take what appeared to be greater than normal risks in providing financing for borrowers whose long-term funded debt reached a level up to three times tangible net worth.

The key factor, of course, was the value of the franchise, the operating authority, the hidden asset on the balance sheet serving to provide a fall-back position for both lenders and investors in the event of unforeseen financial stress.

The operating authority, in fact, played a dual role in attracting institutional financing. On the one hand, justifying the extension of credit which might otherwise have been unavailable and on the other, serving as direct collateral.

Over the years we have frequently taken security interests in authorities as the means of bolstering our collateral position with marginal borrowers. Somewhat less frequently, but nevertheless on occasion, we have utilized authority as collateral to enable existing customers to expand their operations and increase their debt leverage by acquisition of assets or stock of other carriers.

In addition, in functioning as secondary backup collateral for loans, operating authorities have enabled carriers to finance other assets such as revenue equipment and accounts receivable at advance rates exceeding normal standards. Whereas banks traditionally have insisted on downpayments of 10 to 20 percent against equipment purchases and reserves of 20 percent or more for uncollectible receivables, the availability of a second source of collateral has, in certain instances, permitted a borrower to obtain a more liberal extension of credit.

The decade of the 1970's witnessed a monumental change in the direction of the pendulum as far as the value of operating authorities is concerned.

Around the middle of the decade, the financial failure of a number of large carriers brought about a series of asset auctions through the bankruptcy courts. Prominent among the assets offered for sale were sets of operating authority often packaged for purchase by smaller carriers.

Prices obtained through the courts and through some private sales were frequently quite substantial even though the acquiring carriers did not gain any book of business or any market share directly through the purchase.

Toward the other extreme, at the end of the decade, such values tended to diminish with a change in attitude and administrative action within the ICC as the possibility of greater freedom of entry through regulatory reform became realistic. In that climate, the attitude of our bank as lender has undergone a radical swing as well. As prudent lenders we have been forced to become more selective.

We have extensively revised our program of calling on prospects giving high priority to larger carriers with proven records. Moreover, we have reacted decisively to financial weakness in our existing customer base, consistently refusing to extend the terms of loans in default and often encouraging managements of weaker carriers to reach the difficult decision to liquidate.

Our loan portfolio mix has already reflected this change. The number of borrowers has declined as customers have gone out of business or sold to stronger carriers and the average size of our loans has risen through attrition in the ranks of the smaller borrowers.

Our early recognition of the potential decline in the value of authority and concurrent loss of collateral value has been more than vindicated by the impact of the Motor Carrier Act of 1980.

Through regulatory reform, the earlier administrative actions of the ICC increasing the rate of grant of operating authority was substantiated by law. The public utility concept was impaired and the value of operating authority virtually eliminated.

In light of the financial loss experienced by the motor carrier industry, as a whole and the companies within it individually, resulting from actions over which they had no direct control, we believe that some form of financial relief is justified.

We understand that legislative action through Senate bill 702, to provide for deducting from taxable income over a 36-month period the investment in motor carrier authority, is under consideration and we wish to record our support for such a measure.

Thank you very much.

Senator PACKWOOD. Thank, you Mr. Pierce. I appreciate hearing from somebody that is on the other end of the trucking business, in the sense of making the loans because we have heard from the motor carriers frequently. I think the position is justified and you, indeed, bring a banking viewpoint that is helpful.

Lloyd, any questions?

Senator BENTSEN. Why, I might make the comment, Mr. Chairman, first, I am pleased you are holding these hearings.

Second, there is no question that the Motor Carrier Act diminished the value of these motor carriers' operating rights and I think, through no fault of their own and often with their adamant opposition, as I recall. Certainly, they should be allowed the ordinary chargeoff over the 36 months and I am very pleased to join you in supporting this legislation.

Senator PACKWOOD. Gentlemen, thank you very much. I have no questions. I hope we can attach to the tax bill as soon as possible.

[The prepared statements of the preceding panel follows:]

TESTIMONY OF

MARVIN H. LOURIE
EXECUTIVE VICE-PRESIDENT

RENTAR INDUSTRIES
BURBANK, ILLINOIS

COMMITTEE ON FINANCE
SUB-COMMITTEE ON TAXATION AND DEBT MANAGEMENT

UNITED STATES SENATE

MAY 8, 1981

THANK YOU, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE FOR THE OPPORTUNITY TO APPEAR BEFORE YOU CONCERNING SENATOR BAUCUS' BILL, S.702. I REQUEST THAT MY FULL WRITTEN STATEMENT, AS WELL AS MY REMARKS TODAY, BE INCLUDED IN THE RECORD.

MY NAME IS MARVIN LOURIE. I AM EXECUTIVE VICE-PRESIDENT OF RENTAR INDUSTRIES IN BURBANK, ILLINOIS. MY COMPANY IS THE NATION'S LARGEST PRIVATELY OWNED TRUCKING DISTRIBUTION SYSTEM OF MEAT AND PROCESSED FOOD. WE OPERATE IN 48 STATES AND LAST YEAR HAD GROSS TRANSPORTATION REVENUES OF $162,500,000. I STRONGLY SUPPORT S.702, AND URGE POSITIVE AND RAPID ACTION ON THIS LEGISLATION WHICH IS SO CRITICAL TO THE FINANCIAL STABILITY OF OUR INDUSTRY.

WE, LIKE MANY OTHER MOTOR CARRIERS OF OUR SIZE, ARE IN A WORSENING FINANCIAL POSITON DUE TO THE ENACTMENT OF THE MOTOR CARRIER REFORM ACT OF 1980. BEFORE DEREGULATION, WE AT RENTAR INDUSTRIES HAD ON OUR BOOKS OPERATING CERTIFICATES VALUED AT $2.8 MILLION. THESE WERE VERY REAL ASSETS TO THE COMPANY. THEY WERE INCLUDED IN THE VALUE OF OUR ENTERPRISE, WERE USED AS COLLATERAL FOR BORROWING, AND WERE GENERALLY SIMILAR TO FRANCHISE OR LICENSE VALUES IN OTHER INDUSTRIES.

UNLIKE THE LARGE PUBLICLY OWNED COMPANIES THAT UTILIZE PUBLIC EQUITY FUNDS TO FINANCE CAPITAL COSTS, WE ARE DEPENDENT ON BANKS AND EQUIPMENT MANUFACTURER LOANS FOR SUCH FINANCING. WITH HIGH INTEREST RATES, IT IS DIFFICULT FOR US TO BORROW NECESSARY FUNDS TO COVER CAPITAL COSTS; AND THE LOSS OF $2.8 MILLION IN OPERATING

RIGHTS, WHICH WERE ACCEPTED BY BANKS AS COLLATERAL FOR LOANS, HAS SERIOUSLY AFFECTED OUR ABILITY TO DO BUSINESS.

RENTAR FOLLOWS A PARTICULAR ECONOMIC CYCLE WHICH INVOLVES A 2 TO 4 YEAR PERIOD OF PROFITABLE OPERATION FOLLOWED BY A 2 TO 4 YEAR PERIOD OF UNPROFITABLE OPERATION. WE HAVE JUST ENTERED INTO THAT PERIOD OF UNPROFITABLE OPERATION. MANY OTHER MOTOR CARRIERS ARE ALSO ENTERING THIS UNPROFITABLE PERIOD, AND ARE IN SERIOUS FINANCIAL TROUBLE. WITH THIS LEGISLATION, WE WOULD RECEIVE A REFUND OF $355,632 OVER THE THREE YEAR PERIOD, BECAUSE OF THE ORDINARY LOSS DEDUCTION.

THIS ORDINARY LOSS DEDUCTION WILL ALLOW RENTAR TO CONTINUE TO OPERATE WITH FINANCIAL STABILITY. THE REAL VALUE OF THE OPERATING RIGHTS WILL NOT BE REPLACED, BUT THIS DEDUCTION CAN STABILIZE OUR SITUATION.

THEY WERE REAL ASSETS. FOR INSTANCE, IN 1962, RENTAR PURCHASED OPERATING CERTIFICATES FROM A BANKRUPT COMPANY FOR $213,000. IN 1965, WE PURCHASED A TRUCKING COMPANY FOR THE PRICE OF $690,000; $514,796 OF THAT PRICE APPLIED TO THE PURCHASE OF OPERATING CERTIFICATES. ALSO, IN 1969, WE PURCHASED OPERATING CERTIFICATES FROM A COMPANY FOR $500,000. THESE ASSETS HAVE BEEN ELIMINATED BY THE MOTOR CARRIER REFORM ACT OF 1980. THIS LEGISLATION CAN STABILIZE THIS SITUATION. I ENCOURAGE YOUR SUPPORT OF THIS LEGISLATION.

THANK YOU, MR. CHAIRMAN.

SUMMARY OF STATEMENT OF ROGER BURBAGE
O'BOYLE TANK LINES, INC.
ON BEHALF OF THE
AMERICAN TRUCKING ASSOCIATIONS, INC.

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
MAY 8, 1981

Thank you, Mr. Chairman and Members of the Committee for the opportunity to appear concerning a tax matter of grave importance to the regulated motor carrier industry. I request that my full written statement, as well as my remarks today, be included in the record.

My name is Roger Burbage. I am Vice President, Finance and Administration, O'Boyle Tank Lines, Inc. of Rockville, Maryland. I appear here today on behalf of the American Trucking Associations, Inc., ("ATA") the national federation of motor carriers having affiliated associations in every state and the District of Columbia.

The regulated motor carrier industry is composed of over 17,000 firms, 13,000 of which have gross revenues of less than $500,000 annually. Our industry directly employs over 600,000 persons. Total revenues for 1979 were over $40 billion.

The Motor Carrier Act of 1980, which became effective July 1, has made substantial changes in the industry. Of importance here, the value of our operating rights which were previously acquired, usually at significant expense, were rendered virtually worthless, thereby threatening the financial stability of the industry. As was suggested by Congress when the Act was passed, equity demands a legislative solution to our situation.

Today we are asking for tax relief due to the effect of the 1980 legislation on motor carrier's operating rights. Specifically, we are supporting H.R. 1964 introduced by Congressman Holland of South Carolina and S. 702 introduced by Senator Baucus of Montana.

In 1935, Congress established a set of "rules of the game" for the motor carrier industry. For 45 years these "rules" provided for stringent entry controls into the business. In accordance with the rules, trucking firms made substantial capital investments, by purchase or otherwise, to obtain the necessary operating rights. The 1980 Motor Carrier Act, although not totally deregulating motor carrier operations, significantly changed some of the rules by providing far easier entry into the business. Likewise existing motor carriers were permitted to greatly expand their operating authority. The result of the reduction in the value of operating authorities has been the impairment of capital formation in the industry by potentially jeopardizing current loans, making additional borrowing more difficult, and diminishing access to equity capital.

Mr. Chairman, the decrease in value is clearly demonstrable. A 1979 I.C.C. study indicates that operating rights were reflected on the balance sheets as intangible assets and were a very real asset to the carrier. These rights were included in the value of an enterprise and were used as collateral for borrowing. Today, however, these rights have lost their value since trucking companies need simply go through the eased application procedures at the I.C.C. to obtain rights identical to those that were purchased or otherwise obtained at great expense prior to July, 1980. Financial publications such as Value Line have recognized the severe reduction in value for operating rights. In fact, the accounting profession and the I.C.C. have required an immediate, one-time, write-off for book purposes.

The report accompanying the 1980 Act recognized that the new legislation might result in a severe reduction in the value of operating rights and that appropriate tax relief might need to be considered. Mr. Chairman, there is an immediate need for the tax relief discussed at the time Congress passed the 1980 Act, to prevent inequitable and severe competitive impact on existing motor carriers. For example, one trucking company has total assets of about $46 million, of which $18 million are investments in operating rights, largely debt financed. As a result of the new Act the intangible asset represented by operating authority became worthless and total assets drop over one-third to $28 million.

A new entrant into the business today, with tangible assets of say, $35 million, without debt financed operating rights, would be able to effectively compete against the old company and drive it out of business -- all because the rules adopted and encouraged by the U.S. Government for over 45 years were changed overnight. This is not the free marketplace envisioned by those who voted for the Motor Carrier Act of 1980.

Mr. Chairman, under current law, it is arguable that a deduction is already available in these cases. We are proposing an ordinary deduction for the effect of the 1980 legislation on operating rights to preclude costly and time-consuming litigation to determine whether there is a deduction at present. The legislative process provides the most reasoned approach for our industry, the public, and sound fiscal policy.

There is ample precedent for such a legislative solution. Congress has often recognized that severe economic hardships can result when the U.S. Government itself changes the "rules of the game" after taxpayers have expended substantial resources in reliance upon the old rules. In such situations, Congress has provided appropriate tax relief, e.g. the special relief provisions concerning changes in policy by the Federal Communications Commission distributions in obedience to orders of the Securities and Exchange Commission, and persons impacted by the bank holding company legislation.

In summary, Mr. Chairman, the 1980 Motor Carrier Act substantially reduces the value of motor carrier operating rights. Congress anticipated this effect and has already indicated that legislative tax relief may be appropriate. In recognition of this and out of a sense of fair play, it is equitable to allow an ordinary deduction for these operating rights. This deduction is crucial to the financial stability and capital formation capability of this vital American industry.

Thank you, Mr. Chairman.

STATEMENT OF ROGER BURBAGE
O'BOYLE TANK LINES, INC.
ON BEHALF OF THE
AMERICAN TRUCKING ASSOCIATIONS, INC.

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
May 8, 1981

Thank you, Mr. Chairman and Members of the Committee for the opportunity to testify in support of S. 702 to allow an income tax deduction for certain motor carrier operating authorities to offset the impact of the Motor Carrier Act of 1980.

My name is Roger Burbage. I am here today on behalf of the American Trucking Associations, Inc., a national federation of motor carriers, with affiliated associations in every state and the District of Columbia, plus thirteen affiliated national conferences. I am also Vice-President, Finance and Administration, O'Boyle Tank Lines, Inc. of Rockville, Maryland. My company operates in 48 states and has annual gross revenues of about $25 million.

The motor carrier industry is composed of over 17,000 firms, 13,000 of which have gross revenues of less than $500,000 annually. The industry directly employs over 600,000 persons and the regulated industry's total revenues for 1979, the most current available data, were over $40 billion.

The Motor Carrier Act of 1980 made substantial changes in the operation of the federally regulated motor carrier industry. This 1980 Act severely reduces the capital formation capability of the industry by making the value of operating rights acquired by motor carriers and others virtually worthless compared to their previous value. As a result of the 1980 Act, it is arguable that a deductible loss has occurred under current law. The possible prolonged litigation and uncertainty of result from an attempted deduction, without a legislative mandate, will only further adversely affect the industry as well as create administrative problems for the Internal Revenue Service. As was contemplated by Congress at the time of enactment of the Act, the situation demands a legislative solution in the interest of sound tax administration. The purpose of this testimony is to discuss the desirability and necessity of a proposed income tax deduction relating to the effect of that legislation on operating rights. Specifically, we strongly support H.R. 1964 introduced by Congressman Holland and S. 702 introduced by Senator Baucus as the appropriate legislative remedies to this problem.

In 1935, President Roosevelt approved Part II of the Interstate Commerce Act. That legislation provided the basic regulatory framework for interstate motor carrier operation for almost 50 years. That Act provided for certification of operating rights by the Interstate Commerce Commission upon a showing that additional service is or will be required by the public convenience and necessity. Carriers were obligated to offer nonpreferential and nondiscriminatory service at regulated rates. These "rules of the game" provided significant protection from open entry and excessive competition at the cost of regulated rates. Pursuant to these rules and in reliance thereon, companies made substantial capital investments in operating rights (usually by outright purchase from others), which were listed as intangible assets on their balance sheets. Today, more than 17,000 companies hold operating rights pursuant to the provisions of the 1935 Act.

The Motor Carrier Act of 1980, signed by President Carter on July 1, 1980, rendered these operating rights virtually worthless compared to their previous value. This severe reduction in value dramatically affects the financial health of the motor carrier industry. As a clear demonstration of this severe reduction, a brief, but by no means inclusive, series of examples of this devaluation is attached as Exhibit A.

Consequently, current loans may be jeopardized, additional borrowing is more difficult, and access to equity capital is greatly diminished. Let me give you a brief general example. Among the many complex provisions in a typical revolving credit agreement are many covenants concerning current equity requirements, working capital requirements, dividend restrictions, and debt/equity ratios. Also attached as Exhibit B are typical examples of the detrimental effects of the 1980 legislation on financial transactions. A specific example is the situation of McNair Transport, Inc. indicated in its letter. That Texas company found its borrowing capability reduced 200% by the 1980 legislation. This resulted in its inability to purchase tractors and trailers needed to further its business. Moreover, financial institutions have indicated that the borrowing power of motor carriers has been eroded by the 1980 legislation. As will be explained more fully later, the Financial Accounting Standards Board (F.A.S.B.), rulemaking body of the accounting profession, has required a full, one-time, immediate write-off of operating rights for book purposes in the year 1980. (F.A.S.B. Statement No. 44, Dec. 1980). In such a write-off, the companies may be in technical default on loans because loan covenants may be violated. Legislative relief would provide needed financial stability to be considered in negotiating loans.

The 1980 Act, while not totally "deregulating" motor carrier operations, makes substantial changes in the way the industry operates. These changes were designed to substantially increase competition within the motor carrier industry. Among the many changes is easier entry into the industry. Applicants will no longer need to show that service is required under the public convenience and necessity standard. Existing operators protesting a new entrant on a route will bear the considerable burden of showing the proposed service is inconsistent with the public convenience and necessity. In addition, there are limitations on who can oppose applications. The rules for hauling for a corporation under exclusive contract (contract carriage) are vastly liberalized. Further, established truckers may obtain expanded authority with fewer restrictions under the new legislation. Many other areas of truck transportation such as processed foods, agricultural goods, shipments under 100 pounds, government traffic, etc. may now be conducted by carriers simply by demonstrating they are fit, willing and able to provide the service. Finally, certain areas of transportation, for example, highway transportation incidental to air transportation, are totally deregulated.

In short, under the new legislation, the previous significant regulatory restrictions on entry and expansion are almost removed. The new legislation renders operating rights pursuant to the 1935 Act virtually worthless compared to their previous value.

Mr. Chairman, there is uncertainty concerning the proper tax treatment of operating rights after the 1980 legislation. This presents the need for a legislative solution (such as that embodied in H.R. 1964 and S. 702) as a matter of fairness, sound and efficient tax administration, and the national interest in order to maintain a financially sound motor carrier system.

From a Federal income tax standpoint, the cost of operating rights has historically been capitalized. These operating rights _had_ an indefinite life. However, the 1980 Act has required a reexamination of this treatment. Events have demonstrated that the rights which were considered to be "permanent" now have been eroded by law and in fact, now have a finite life.

There is an old case, decided in 1938, _Consolidated Freight Lines, Inc. v. Commissioner_, 37 B.T.A. 576 (1938), in which the then Board of Tax Appeals denied the taxpayer a deductible loss where the State of Washington, which had granted a right to a trucking company, repealed the monopolistic characteristics of the law. The Court of Appeals for the Ninth Circuit, 101 F.2d 813, affirmed the Board's decision in 1939, on the ground that the monopoly was not part of the certificate under which it had previously operated. This case has distinguishable features from the present situation, has been critized by other courts, and the issue has not been tested in other jurisdictions. Therefore, the case is not persuasive as to the correct treatment following the 1980 legislation.

In other cases involving the proper treatment of intangibles, such as the grant of a cable television franchise, the courts have held a deduction depends on the specific facts and circumstances with regard to whether the life of the rights invo ved is determinable or has an indefinite life. In the case of a determinable life, a deduction is proper. Chronicle Publishing Co., 67 T.C. 964 (1977); Toledo T.V. Cable Co., 55 T.C. 1107 (1971).

Further, there is authority for the proposition that the enactment of the Motor Carrier Reform Act of 1980 creates grounds for determining the useful life of operating rights. Consequently, deductions based on the determinable life are proper. Gerrit Van de Steeg, 60 T.C. 17 (1973).

In short, the cases indicate that specific facts and circumstances are very important to the determination of a fixed and determinable life that gives rise to a deduction. The facts and circumstances having an impact on this industry after the 1980 Act suggest a determinable life and deductions are proper.

Alternatively, there is a line of authority that indicates that an ordinary loss deduction may be available under current law for the entire basis of an operating certificate, reduced by amounts allocable to the license aspect and by salvage value, if any. Parmalee Transporation Co. v. U.S., 351 F.2d 619 (Ct. Cl. 1965); Meredith Broadcasting Co. v. U.S., 405 F.2d 1214 (Ct. Cl. 1969); The Transport Company of Texas v. U.S., 26 AFTR 2d 70-5804 (S.D. Tex. 1970); Massey-Ferguson, Inc., v. Commissioner, 59 T.C. 220 (1972), acq. 1973-1 C.B. 1. In other words, a deduction is available for the tax basis in the expected continuation of the restricted entry aspect of an operating rights certificate. This expectancy aspect of the certificate is a clearly identifiable and severable asset.

Companies in the industry have claimed deductions under either or both of the above theories. If disallowed by the Internal Revenue Service, litigation will ensue. Of course, if the deduction is authorized by current law, a legislative clarification would generate no revenue loss.

Further, an abandonment generally leads to a deductible loss under the current law pursuant to § 165 of the Internal Revenue Code. If companies actually abandon an operating rights certificate, as may often occur, a deduction would be proper. A company could therefore abandon a certificate and then apply to the I.C.C. under the new procedures for an expanded authority. This would result in a deluge on the I.C.C., an administrative nightmare and possible disruption of this industry. Therefore, although theoretically possible, this approach is impractical and calls for a legislative solution.

Nonetheless, the determination involved with respect to the deduction of the losses suffered by businesses in the motor carrier industry is a substantial one which, unless another solution is forthcoming, will necessitate costly and time consuming litigation in order to protect vital financial interests. This will create a further period of disruption and uncertainty in the financial status of this vital industry. For the interests of all concerned, a legislative solution is advisable.

As stated, many companies have expended substantial sums, by purchase or otherwise, to obtain operating rights under the previous legislation. That legislation better protected these rights from additional entry and excessive competition on a route.

In some cases, operating rights represent more than 50% of the total book value of a company. An issue to be considered in a legislative proposal would be to determine if the old operating rights have lost value. It is demonstrable that the value of previous operating rights has been reduced to almost nothing, indeed rendered virtually worthless compared to their previous value.

In October, 1979, the Interstate Commerce Commission's Office of Policy and Analysis released a study entitled "The Value of Motor Carrier Operating Rights." The study clearly indicated an active marketplace for operating rights, under Commission supervision and with its consent. Of course, prices varied according to the specific rights bought and sold. The study shows that operating rights were a very real asset to a carrier, functioning much as tangible assets do in other industries. That is, operating rights were included in the value of an enterprise and were a source of collateral for borrowing. These operating rights are generally similar to franchise or license values in other, comparable, nontransportation industries.

The vast reduction of this previous value in operating rights by the new legislation severely impairs capital formation. The decrease may jeopardize current loans outstanding and makes additional borrowing very difficult. Because of the decrease in value, access to equity capital, via the stockmarket or otherwise, will be limited. Overall, the availability of capital for this industry is imperiled by the new legislation. I merely re-reference Exhibits A and B to substantiate these points.

As stated, the previous system provided significant restrictions on the granting of operating rights. These restrictions are no longer present. Therefore, there is no longer an active market in operating rights. This market has been replaced under the new legislation, by obtaining new route authority from the Interstate Commerce Commission by simple application.

This ease of obtaining operating rights under the 1980 Act could have a severe competitive impact on us if tax relief is not forthcoming. Let me give you an example. One of the companies in our industry has total assets of around $46 million, of which $18 million is operating rights, largely debt financed. After the 1980 Act, this company's assets drop over 33% from $46 million to $28 million. A future competitor with assets of say, $35 million, without debt financed operating rights, could come in under the new easier entry of the new law and compete more effectively against the old company and drive it out of business. All because the previous rules adopted and enforced by the U.S. government have now been changed by that same government.

Stock market analysts and economic commentators have recognized the substantial reduction in the value of operating rights. For example, The Value Line Investment Survey of July 11, 1980, page 306, states in its analysis of the trucking industry: "Because of previous I.C.C. regulations, almost all trucking companies have a considerable amount of operating rights, purchased from other companies that are carried on their balance sheets as intangible assets. The current regulatory reform render these rights virtually worthless compared to their previous value."

The legislative history of the Motor Carrier Act of 1980 recognized the new legislation might result in the severe reduction in the value of operating rights and tax relief should be considered. "Should it become apparent that the effect of this legislation has been to substantially erode the value of operating rights, then appropriate relief for such result should be considered as early as possible. Preferably it will be considered by the Committee on Ways and Means." H.R. Rep. No. 96-1069, 96th Congress, 2d Sess. 4,11 (1980).

It is clear that the Motor Carrier Act of 1980 has significantly reduced the value of existing operating rights.

Having determined a severe reduction in value, the appropriate relief is embodied by H.R. 1964 and S. 702. The trucking industry's situation after the 1980 legislation is very similar to a loss situation, via expropriation, casualty, or otherwise. Based on established precedent under § 165 of the Internal Revenue Code, an ordinary tax deduction is the appropriate approach. The general concept of § 165 allows an ordinary tax deduction for losses sustained. Section 165(i), prior to its deletion by the "deadwood" provisions of the Tax Reform Act of 1976, provided a special loss deduction for certain property confiscated by the Government of Cuba. In addition, § 165 authorizes a deduction for general casualty losses and other expropriation type losses have been allowed by the courts, U.S. v. White Dental Mfg. Co. of Pennsylvania, 274 U.S. 398 (1927).

There is other ample precedent for a reasonable legislative solution to this problem. In these situations, Congress has recognized that severe economic hardships can result when the U.S. government "changes the rules of the game" that were set up by that same government and after taxpayers have expended substantial resources in reliance upon the old rules. In these situations, Congress has provided appropriate tax relief to remedy the governmental action. For example, § 1071 provides a special nonrecognition provision concerning the sale or exchange of property pursuant to a change of policy or a new policy of the Federal Communications Commission. Likewise, § 1081 provides for nonrecognition of gain in an exchange or distribution in obedience to orders of the Securities and Exchange Commission. Finally, §§ 1101-1103 provide special relief provisions for persons impacted by the 1956, 1966, and 1970 bank holding company legislation.

A tax legislative solution providing an ordinary deduction permits a proper analysis of the economic impact of the 1980 legislation on the motor carrier industry.

For equitable reasons and due to the unique nature and origin of the rights involved, it might also be appropriate to base the deduction on the higher of (1) adjusted basis or (2) $50,000. This solution recognizes that many small firms have had their most valuable asset, the operating rights, severely impacted by the new legislation. A deduction for only the adjusted basis of the operating rights in no way recognizes their economic loss. These small firms play a vital role in the trucking industry. These entrepreneurs and smaller business people are often the first to feel the strong hand of government policy and any changes in that policy. The individuals involved in these smaller firms have planned on the value of existing operating rights being their financial underpinning. For these individuals, the effect of the 1980 Act is particularly harsh.

It should be noted that there are no artificial allocation problems in the allocation of price between goodwill and operating rights. Amounts paid for either did not give rise to any tax deduction for depreciation or amortization under prior practices. These allocations have already been made and approved by the Interstate Commerce Commission and are a matter of public record. The amounts paid or expended for operating rights reflect economic reality and do not reflect goodwill. This is particularly true in many purchases of other companies. Many companies purchased were failing or bankrupt companies. In most of these cases, "goodwill" was negative in character and the new companies had to immediately take affirmative action to correct the deficiencies. However, the ultimate determination, under a legislative solution, should be left to the facts and circumstances of the particular case, to be decided by the taxpayer and subject to the normal audit procedures of the Internal Revenue Service.

The last aspect of the deduction to be discussed is timing. The most desirable, least complex, and most accurate recognition of the effect of the Motor Carrier Reform Act of 1980 would be to allow an immediate deduction, as now recognized by the I.C.C., F.A.S.B., and S.E.C. for book purposes. When President Carter signed this legislation on July 1, 1980 the existing operating rights were essentially rendered virtually worthless compared to their previous value. However, to ameliorate any revenue loss impact over a period of time, the Congress may want to spread the deduction over 3 years. Some aspects of the Motor Carrier Act of 1980 are "phased in" over 3 years and it may be reasonable to make the tax provision similar as provided in H.R. 1964 and S. 702.

One technical change merits discussion. Some companies, because of prudent business reasons and considering current tax practices, chose not to liquidate subsidiaries, the stock of which they had purchased. This resulted in the fair market value attributable to the operating rights remaining in the basis of the stock rather than raising the basis of the operating rights. During Committee consideration of the legislation, consideration should be given to this problem. One solution might be to provide a deemed increase in the basis of the operating rights with a commenserate decrease in the basis of the stock, then allowing the company a deduction which more clearly reflects economic reality.

Before I conclude, let me briefly discuss the accounting procedures for operating rights and the revenue loss estimate for our proposal. Motor carriers have accounted for operating rights in accordance with the procedures promulgated by the Interstate Commerce Commission under its uniform system of accounts. In addition those carriers which are publicly held and those whose books have been audited by independent public accountants have accounted for operating rights in accordance with generally accepted accounting principles.

Operating rights have been classified in the intangible accounts prescribed by the I.C.C. whether such costs arose from application to the Commission or whether such costs arose as a result of outright purchase or by merger or combination of corporate entities. In all such cases the procedures followed and classifications used for operating rights were based upon pronouncements of the I.C.C. or authorizations granted after proceedings held before the I.C.C.

Under generally accepted accounting principles in effect before December, 1980, operating rights acquired after 1970 had been amortized generally over a period not to exceed 40 years. The I.C.C. did not permit amortization or dispostion of carrying costs of operating rights unless there had been impairment or diminution of value. However, in view of current developments contained in the Motor Carrier Act of 1980 and recent Commission decisions, the I.C.C. Bureau of Accounts has approved the issuance of Accounting Series Circular No. 188, Accounting for Intangible Assets. The I.C.C. has changed its accounting to conform its practices with the new generally accepted accounting principles which require an immediate, one time deduction for book purposes, because such legislative actions and recent Commission decisions impaired or diminished the market value of carrier operating rights.

Mr. Chairman, the revenue loss of our proposal, assuming there is no deduction under current law would be about $363 million, based on the latest available data. Of course, if these rights are deductible after the 1980 Act under current law, there is no revenue loss.

In summary, the Motor Carrier Reform Act of 1980 has had a profound effect on the motor carrier industry. One unfortunate

82-820 O—81——5

effect was to significantly reduce the value of operating rights held by various companies. Congress anticipated that certain tax problems would arise and should be addressed by the tax writing committees. Rather than costly and time consuming litigation with uncertain results to both the industry and government, the proper solution is legislative. The legislative process provides the reasoned approach that accounts for industry, public and fiscal considerations. In recognition of all this, it is appropriate to allow an immediate ordinary income tax deduction for these operating rights. This deduction is crucial to the financial stability and capital formation needs of the industry.

The enactment of the Motor Carrier Act of 1980 anticipated the problem outlined above and invited a legislative solution such as we are seeking.

Thank you, Mr. Chairman.

EXHIBIT A

EXAMPLES OF DEVALUATION OF OPERATING RIGHTS ACQUIRED THROUGH PURCHASES

With the passage of the Motor Carrier Act of 1980, the once significant restrictions on the granting of operating rights are no longer present. Consequently, the once active market for purchase of operating rights has been replaced, under the new legislation, by obtaining new route authority from the Interstate Commerce Commission (ICC) through simple application.

Consider, that in 1976, the ICC staff included 100 Administrative Law Judges whose responsibilities included the review of operating rights application cases. In that same year only 4,700 applications were granted by the Commission. By contrast, in October of 1981 there will be only 12 Administrative Law Judges and for fiscal year 1980, the ICC has granted 22,076 applications, or 99.6%. Further, since July 3, 1980, (two days after enactment of the Act) the Commission has granted 16,033 common carrier applications and denied 94.

Perhaps the ultimate illustration of how the value once attributable to the restricted entry feature of operating rights has eroded is the grant on January 30, 1981 of Consolidated Freightway's application for all points and places in the contiguous United States. The application was filed on August 14, 1980, with fewer than 75 supporting shippers and was not even subject to oral hearing.

To date, nine applications to transport general commodities nationwide have been granted. Such applications would have been unthinkable only three or four years ago. Under the environment which existed as late as 1976 or 1977, a substantial general commodities carrier could not realistically expect to expand into significant new markets by means of a public convenience and necessity application. If it chose to try, its burden in developing massive shipper support and documentation of existing service inadequacy was enormous and the case would have taken years, and perhaps hundreds of thousands of dollars, to pursue. The only logical course for such a carrier which hoped to expand territorially was to purchase existing authority when it was available and that, of course, is why such authority was readily marketable and very valuable. Now that authority can be obtained in timely fashion merely by application, the purchase of interstate rights standing alone for any significant sum is not a realistic option.

The following are typical transactions which further illustrate the devaluation of operating rights acquired through purchases:

(1) In 1976, Wilson Freight Company purchased rights between Atlanta, GA and Cincinnati, OH for $2.45 million, from a large carrier, Associated Transport, which had gone bankrupt.

In the third quarter of 1980, merely four years later, Wilson itself closed its doors and filed for protection under Chapter XI. The company has been running full page ads in the trade press to liquidate its equipment and although Wilson's extensive operating authority in 30 states generated 1979 revenues of $165 million, this company, unlike Associated, has been unable to sell those rights for any material sum. Instead, other carriers have entered the markets (formerly served by Wilson) by direct application with the ICC. Indeed, Murphy Motor Freight sought and was granted temporary authority to serve Atlanta from Cincinnati--the same rights that Wilson a short while ago had paid nearly two and one-half million dollars for.

(2) In 1977, Roadway contracted to sell certain specific "heavy hauler" authority, acquired from Western Gillette and extending from California to Texas, to an existing specialized carrier, BHY Inc., for $500,000. As the purchase case proceeded before the ICC, BHY, seeing how entry was being liberalized, balked and attempted to defeat the approval of their own purchase on fitness grounds. The Commission, however, in both the initial decision and appeal level approved the sale and its terms. The Commission's decision acknowledges that it is now considerably easier and quicker for trucking companies to attain authority by application, but also found that the contract had been reached at arms length negotiations and that carriers should bear responsibility for assessing their business risks. The Commission stated in this case:

> "We are not insensitive to the fact that the purchaser's perception of the value of the operating rights it is obtaining may well be different from its perception of 3 years ago. The requirement of regulatory processing undoubtedly contributed to that change in perception. But BHY's fundamental problem is the change in the regulatory climate which has occurred during the intervening 3 years since it negotiated the original contract. From our perspective, the change in regulatory climate -- which, after all, has affected the entire industry -- is an element of ordinary business risk which must, in the last analysis, be borne by the contracting parties."

(3) On February 18, 1977, McLean Trucking Company filed a finance application to purchase the capital stock of Wolverine Express, Inc. of Muskegon, Michigan

for $4,000,000. The application (docket #MC-F-13133) was consummated on September 30, 1977. Ryder Truck Lines, Inc. filed an application on September 26, 1980, for a public convenience and necessity certificate which duplicated McLean's purchase (docket #MC-2900 (437) and the application was granted by the ICC.

(4) Ryder Truck Lines, Inc. filed an application to purchase a portion of Associated Transport, Inc.'s authority in New Hampshire and Maine (docket #MC-F-12913) for $1,300,000. Said application was filed with the ICC on July 12, 1976, and consummated May 19, 1978. On December 31, 1979, Roadway filed an application for a public convenience and necessity certificate which duplicated this purchase. This application (docket #MC-2202 Sub 627) was granted by the Commission.

(5) Graves Truck Lines, Inc. purchased a portion of Western Gillette, Inc. for $2,000,000 for authority between Dallas, TX and Oklahoma City, OK. Churchill Truck Lines, Inc. also purchased a portion of Western Gillette for $1,750,000 between Dallas, TX and Kansas City, MO. These applications were filed on March 14, 1977 (docket numbers MC-F-13161 and MC-F-13159, respectively). Graves consummated its purchase on January 31, 1979, and Churchill on March 20, 1979. In September 1978, Texas Oklahoma Express, Inc. filed a duplicating public convenience and necessity application (docket MC-116004 Sub 45) and the rights were granted.

(6) Roadway Express, Inc. purchased the capital stock of Howard Hall, Inc. for $10,197,007 of which $6,500,000 was operating rights. The finance application was filed (docket #MC-F-12485) on April 8, 1975, and consummated on September 30, 1977. Mason and Dixon Lines, Inc. filed a duplicating public convenience necessity application on January 26, 1979, (docket MC-59583) (Sub 1970) which is currently pending and expected to be granted by the ICC.

(7) Lee Way Motor Freight, Inc. purchased a portion of Associated Transport's operating rights to serve points in North Carolina and South Carolina for $5,400,000. The finance application was filed on July 27, 1976, (docket #MC-F-12905) and consummated August 22, 1977. Mason and Dixon, Murphy Motor Freight and Interstate Motor Freight System have filed duplicating public convenience and necessity applications, all of which are pending.

(8) Roadway Express, Inc. purchased Knoxville-Maryville Motor Express' operating rights in eastern Tennessee for $670,000. The application (docket #MC-F-12555) was filed on July 24, 1975, and consummated July 8, 1976. In addition on June 9, 1976, Roadway filed an application to purchase Superior Trucking Service's operating rights in central Tennessee for $775,000 (docket #MC-F-12866). This purchase was consummated June 29, 1977. Also, Roadway purchased West Tennessee Motor Express' rights for $600,000. This application was filed on June 18, 1979, (docket #MC-F14090) and consummated on December 8, 1979. Finally, Roadway purchased rights in northern Georgia from Meadors Freight Lines for $385,000. This

application was filed on July 27, 1976, (docket #MC-F-12906) and consummated on December 8, 1979. Mason and Dixon filed public convenience and necessity applications, which duplicated all of the Roadway purchases, in an application filed January 26, 1979, (docket #MC-59583) (sub 170), and AAA Cooper Transportation filed on December 18, 1980, (docket #MC--55889) (Sub 64). Both applications are pending before the Commission.

(9) Consolidated Freight Ways purchased the operating rights of Baggett Transportation for $5,500,000 to serve various points in Alabama and Mississippi. The application was filed on May 15, 1977, (docket #MC-F-13224) and consumated on January 3, 1978. AAA Cooper filed a corresponding public convenience and necessity application on September 25, 1979, (docket #MC-55889) (Sub 55) and the application was granted by the ICC.

(10) Smith Transfer acquired Reliable Transportation's operating rights for $2,067,206 in an application filed June 30, 1977. This purchase (docket #MC-F-13274) was consummated on September 14, 1978. Smith also purchased M.R.&R. Trucking whose operation was in Alabama and Florida for $3,277,587. The application was filed on August 8, 1977, (docket #MC-F-13303) and consummated on January 1, 1978. AAA Cooper filed a corresponding public convenience and necessity application on May 22, 1980, (docket #MC-55889) (Sub 62) and again was granted by the ICC.

To summarize, the aforementioned, but by no means inclusive series of examples, illustrates that the Motor Carrier Act of 1980 has rendered operating rights virtually worthless compared to their previous value. In light of these developments, the views of financial institutions on the worth of operating rights have undergone a similar conversion. Consequently, current loans may be jeopardized, additional borrowing is more difficult, and access to equity capital greatly diminished. In essence, government fiat has almost entirely changed a pattern of economic regulation and private enterprise response that had existed for almost 50 years.

MCNAIR TRANSPORT INC.

EXHIBIT B

September 11, 1980

The Honorable Lloyd Bentsen
United States Senate
Washington, D. C. 20510

Dear Senator Bentsen:

I am writing you in reference to HR-5829, the Major Tax Cut Bill.

In 1971 we purchased a motor carrier of petroleum products. At that time we paid $971,042.00 for the operating rights that were acquired. The Motor Carrier Act of 1980 has rendered these operating rights valueless which creates a severe hardship on our part. We have been writing off the value of these operating rights over a forty (40) year period as was prescribed by the Accounting Principles Board.

These rights are presently on our books for $757,042.00. The stockholders' equity in our company as of June 30, 1980 is $1,093,712.00. After reducing our total assets by the write-off of our operating rights our stockholders' equity is reduced to $336,670.00.

For some time I have been negotiating with a commercial bank for a line of credit in the amount of $3,000,000.00 which is needed in order to finance the heavy expenditures required for the truck tractors and trailers employed in our business. One of the key financial ratios that had been negotiated with the bank was the debt to equity ratio. It was agreed that debt could be no more than three times stockholders' equity. In our case this would have been $3,281,136.00 and the loan request for $3,000,000.00 was within the ratio limit. Last week, however, after reading the article in the Wall Street Journal on the Motor Carrier Act of 1980 our bank determined that our operating rights should be written off our books. Therefore, our stockholders' equity in their view is $336,670.00 and our borrowing would be limited to $1,010,010.00. Needless to say, the reduced line of credit is totally inadequate and cannot possibly meet the needs of our business.

I understand that your committee is considering an amendment that would allow carriers to write off the value of their operating rights against future income taxes as a result of the loss in value brought about by the Motor Carrier Act of 1980. Such action on the part of Congress would not compensate us for our loss since the operating rights were bought with after-tax dollars nine years ago. However the opportunity for a tax deduction equal to the current market value of the rights immediately prior to the enactment of the beforementioned law would diminish our loss.

Everyone laments about the problems that a small businessman faces everyday but it is very seldom that assistance is rendered. The experience I have related to you is possibly being repeated all over the country. I hope that you will feel a moral obligation to replace at least part of the value that has been taken away from us. I hope that we can count on you for your help.

Yours very truly,

McNAIR TRANSPORT, INC.

Robert C. McNair
President

RCMc:mar

NOTE: This letter was sent to the following:

Senators: Russell B. Long, LA
Lloyd Bentsen, TX
Robert Dole, KA

Representatives:
Bill Archer, TX
Philip M. Crane, IL
W. Henson Moore, LA

EXHIBIT B

THE FIRST NATIONAL BANK OF BOSTON
BOSTON, MASSACHUSETTS 02110

March 23, 1981

Congressman Kenneth L. Holland
2431 Rayburn Office Building
Washington, D. C. 20515

RE: H. R. 1964

Dear Congressman Holland:

We have established, over the past quarter century, a reputation as one of the principal lending banks to the motor carrier industry. In terms of the dollars committed and the number of carriers served, we would certainly place among the top five commercial banks in that category. Moreover, our role as direct lender has been extended to many other lending institutions, both banks and insurance companies, through syndicating larger credits and acting as agent for all the lenders.

In order to assume such a position of responsibility, we determined at the outset that we should learn as much as possible about the financial characteristics of the industry we viewed as a target for new business. We understood the essential nature of the service provided by motor carriers to the general public and recognized immediately the public utility concept embodied in the grant of operating authorities for "the public convenience and necessity". On the other hand, we also realized, through financial analysis, that the motor carrier industry of the late nineteen fifties and early nineteen sixties was relatively highly leveraged with respect to the traditional relationship between debt and equity. Our analytical efforts, we might add, were aided and abetted by our willingness to prepare the early versions of The Banker's Analysis of the Motor Carrier Industry, an officer of our bank having authored four of the first six analyses.

Our initial conclusions, which proved valid for at least twenty years, encouraged us to become relatively aggressive lenders to a fledgling industry, to take what appeared to be greater-than-normal risks in providing financing for borrowers whose long-term funded indebtedness reached a level up to three times tangible net worth. The key factor, of course, was the value of the franchise, the operating authority, as a hidden asset on the balance sheet, serving to provide a fall-back position for both lenders and investors in the event of unforeseen financial stress.

THE FIRST NATIONAL BANK OF BOSTON

The operating authority, in fact, played a dual role in attracting institutional financing, on the one hand justifying the extension of credit which might otherwise have been unavailable, and on the other hand serving as direct collateral for loans. Over the years, we have frequently taken security interests in operating authorities as the means of bolstering our collateral positions with marginal borrowers. Somewhat less frequently, but nevertheless on occasion, we have utilized operating authorities as collateral to enable existing customers to expand their operations and increase their debt leverage by acquisitions of assets or stock of other motor carriers.

In addition, in functioning as secondary or back-up collateral for loans, operating authorities have enabled carriers to finance other assets, such as revenue equipment and accounts receivable, at rates of advance exceeding normal standards for bank lenders. Whereas banks traditionally have insisted on down payments of 10-20% against equipment purchases and reserves of 20% or more for uncollectable receivables, the availability of a second source of collateral has, in certain instances, permitted a borrower to obtain a more liberal extension of credit.

The decade of the nineteen seventies witnessed a monumental change in the direction of the pendulum as far as the value of motor carrier operating authorities is concerned. At one extreme around the middle of the decade, the financial failure of a number of large carriers brought about a series of asset auctions through the bankruptcy courts, and prominent among the assets offered for sale were sets of operating authorities, often conveniently subdivided for purchase by smaller carriers. Prices obtained through the courts and through some private sales were frequently quite substantial, even though the acquiring carriers did not gain any book of business or any market share directly through their purchases. Toward the other extreme in subsequent years, however, such values tended to diminish with a change in attitude and administrative action within the ICC as the possibility of greater freedom of entry through regulatory reform became more realistic.

In that regulatory climate, the attitude of our bank as a lender in the industry has undergone a radical swing as well. As prudent lenders, we have been forced to become much more selective with respect to both new borrowers and existing customers. We have extensively revised our program of calling on prospects, giving high priority to larger carriers with proven track records while rejecting most prospective borrowers with debt leverage in excess of twice tangible net worth. Moreover, we have reacted decisively to financial weakness in our existing customer base, consistently refusing to extend the terms of any loans in default and often encouraging managements of weaker carriers to reach the difficult and painful decision to liquidate to avoid further erosion. Our loan portfolio mix has already reflected this change in perception. The number of borrowers has declined as customers have gone out of business or sold to stronger carriers seeking increased market penetration, and the average size of our loans has risen through attrition in the ranks of the smaller borrowers.

THE FIRST NATIONAL BANK OF BOSTON

Congressman Kenneth L. Holland -3- March 23, 1981

Our early recognition of a potential decline in the value of operating authority and a concurrent loss of both collateral value and a fall-back position for lenders and investors in the motor carrier field was more than vindicated by the impact of the Motor Carrier Act of 1980. Through regulatory reform, the earlier administrative actions of the ICC in significantly increasing the rate of grant of new operating authorities were substantiated by law, the public utility concept was impaired, and the value of operating authority virtually eliminated. As suggested above, certain carriers can no longer obtain financing; certain others, having recently purchased operating authority through the courts or in the open market, subject to the formality of approval from an administrative body of government, a creature of the Congress, find their investments rendered valueless. Government fiat has essentially altered a pattern of economic regulation and private enterprise response which had prevailed for nearly half a century.

In light of the financial loss experienced by the motor carrier industry as a whole and the companies within it individually, resulting from actions over which they had no direct control, we believe that some form of financial relief is justified. We note that the prestigious Transportation Association of America, comprised of carriers and transportation companies in all the modes and, more significantly in this case, of both transportation users (shippers) and investors, has formulated a policy position in favor of specific tax relief for motor carriers. We understand further that legislative action through H. R. 1964 to provide for deducting from taxable income over a 36-month period the investment in motor carrier operating authority is under consideration, and we wish to record our support for such a measure. As evidence of this support, we request that you include this letter in the record of the proceedings.

Sincerely

THE FIRST NATIONAL BANK OF BOSTON

Laurence A. Pierce
Vice President

LAP/ar

Republic National Bank
of Dallas

Jim P. Wilson, Jr.
Senior Vice President

EXHIBIT B

April 16, 1981

The Honorable Kenneth L. Holland
Rayburn Office Building
Room 2431
Washington, D.C. 20515

Dear Congressman:

Re: H. R. 1964

Republic National Bank of Dallas has long been a major lender to the transportation industry as we have recognized the great importance that this industry has on the entire economy of the United States. We were concerned about the Motor Carrier Regulatory Reform Act of 1980 effect on the trucking industry. Part of our concern dealt with the freedom of entry and its impact on those carriers who historically have paid for the right to position themselves in certain selected markets. We still believe that government regulation of this industry was necessary to achieve some sort of stability and think that since the act has now been passed that there will be some disarray in the country and those trucking firms that have a sound capital position will weather the storm but it will not be easy. Our bank, along with other banks, has loaned money to the trucking industry based on their route system, their management, their load factors, their equipment and obviously their cash flow. The collateral base has historically been the rolling stock and in some cases the operating authorities and permits have been taken. Whether taken as collateral or not, we all considered the operating rights as sound collateral should anything happen that would cause a particular company to get into financial difficulties. In the past some companies have gone into bankruptcy and the salvage for the company and the stockholders has been the sale of the operating rights to other firms. We now consider this asset as having no value and consequently are rethinking our lending procedures and will be more strict in our credit reviews of the motor carry industry.

Since the Motor Carrier Act was forced on the industry, even though there was overwhelming opposition to the deregulation act, from both the industry and financial community, it seems to us that there now has to be concession from the Internal Revenue Service to allow the companies an ordinary income tax deduction for the loss of the value of the operating rights. This is no longer a viable asset with no value and in our opinion should be written off.

We believe it is very important to the industry and very important to the acquisition of future financing that Congress support the operating authority tax deduction bill and we urge you to support this bill during your committee hearings this year.

I am enclosing a copy of an article written prior to the passage of the Motor Carrier Regulatory Reform Act which expressed some of the views of Republic National Bank. Even though this article will be redundant and past history since the act was passed, it will give you an indication of why we were strongly opposed to some of the deregulation and how we felt about the freedom of entry question and the relationship of the operating certificates.

If there are any questions which you might have, we urge you to contact us at any time.

Respectfully submitted,

Jim P. Wilson, Jr.
Senior Vice President

Enclosure

JPW/gj

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COMMENTARY

Banking impact from truck deregulation cited

Congressional legislation to deregulate the trucking industry is at a decisive stage, and could clear Congress and be on the president's desk by June 1, according to Jim P. Wilson, senior vice president at Republic National Bank of Dallas.

In the following article, written for Dallas/Fort Worth Business, Wilson concludes deregulation would have devastating impact upon not only the trucking industry but all other businesses that must ship or receive goods and upon banks which make loans to the trucking industry.

He advocates very careful consideration before changing regulation practices that have worked well for many years. He also notes a survey by the U.S. Department of Transportation showed over 97 percent of shippers are satisfied with the service they get from presently regulated motor carriers.

If you have a subject you feel would be of interest to readers, please contact Dallas/Fort Worth Business.

Anyone who ships or receives products and supplies via motor carrier should take the time to study proposals before the Congress that would deregulate the trucking industry. Bankers and other lenders should take special interest in this issue.

Deregulation advocates' claims -- that trucking regulation creates excessive profits for the industry, and is inflationary, anticompetitive, fuel inefficient and disruptive to service — should be examined closely before any changes are advocated in the truck transportation system that the nation enjoys today.

The movement to deregulate the trucking industry is at a decisive stage. According to the schedule set by congressional leaders, the legislation is to clear the Congress and be on the president's desk for his signature by June 1.

Amidst all this deregulation rhetoric in Washington, it is ironic that neither the public nor shippers (except for a few large shippers) are calling for deregulation of the trucking industry; in fact, a survey of shippers by the U.S. Department of Transportation shows that over 97 percent are satisfied with the service they get from regulated motor carriers.

Deregulation of the trucking business has some serious problems. Government officials and congressional leaders who are sponsoring deregulation legislation, apparently, do not understand the mechanics or economics of the nation's trucking industry; otherwise, they would never have proposed dismantling a motor carrier system which works so well that most of us take it for granted.

Further, in my opinion, legislators simply don't understand the public benefits of economic regulation, and they don't remember the chaos that existed prior to economic regulation (pre-1935). Certainly, they have not looked into the total ramifications of the deregulation bills before the Congress.

It is imperative that we search diligently for the truth in this issue. The consequences of overlooking or ignoring the truth could be disastrous.

We have recently experienced a small-scale example of what can happen when truth becomes obscured by the ideology of deregulation. I'm referring to deregulation of the airlines.

For a brief period following enactment of airline deregulation, it looked like the advocates of that action were going to be justified. The airlines were able to cut their fares and attract unprecedented numbers of passengers. But, lately the bloom has faded from the

continued

rose. With new found discretion to restructure schedules for the sake of their bank accounts, the airlines began cutting back on service on less predictable routes. Nationwide, more than 190 cities have lost certificated air service.

Deregulation advocates claimed that commuter airlines would take up the slack in smaller communities, as trunk carriers sought better equipment utilization on more lucrative routes. However, we are already seeing some of the commuter airlines, which tried to make it in smaller communities, pulling out because of high costs of fuel and equipment.

In Congress, there is talk of seeking legislation to remedy the loss of service caused by deregulation. With most

The transportation industry is one of the few industries in the country where most of its revenues are derived from fixed assets.

discussions centered around passenger traffic and routes, very little has been said about airline freight rates which have gone up 50 percent under deregulation.

We predict the same will be true in the trucking business. If economic regulations are removed, there will still be a need for regulations.

There are some critical areas of economic regulations that need to be streamlined or fine-tuned. These changes, which should be described as housecleaning measures, would be far more beneficial to the shipping public than the proposals to provide total freedom of entry and total decontrol of the rate-making device.

The question of freedom of entry is of great concern to the banking community. The high cost of capital makes it necessary for not only banks, but for any organization to take a closer look at its operations. The cost of equipment in the motor carrier industry has nearly doubled over the last five years. To finance the motor carrier fleet, more and more companies have to rely on external debt. Part of the cost of this equipment is pollution-control devices or safety equipment, which produce no revenue. As in the utility industry, where now approximately 40 percent of the cost of a coal-fired generating facility is made up of pollution-control devices (non-revenue producing), the trucking industry is also faced with expensive items that do not produce revenue. These, however, must be paid for.

The cost of capital is expensive too. Not only the interest cost, but the acquisition cost for available capital is expensive.

In the past, the banking industry has basically loaned to the trucking industry under a borrowing base formula. This, historically, was 80 percent of the depreciated value of rolling stock. However, because of the high cost of a unit for the last several years, this borrowing base has been altered. In some cases, a static figure of 80 percent of depreciated rolling stock, plus a dollar amount, or unencumbered property, has been included just to make the debt follow some basis, which is somewhat cosmetic in nature.

All of this is just further indication that the industry cannot support the borrowing on strictly its rolling stock. The transportation industry is one of the few industries in the country where most of its revenues are derived from fixed assets, and more and more companies have to rely on external debt either through the banking industry

BANKING

Preston State sets credit card

One of the first banks in the Metroplex ... less than the balance each month or institutional lenders

With the high cost of labor and fuel, and the sometimes slowness of rate increases, the income after tax is beginning to slip with operating ratios increasing. As this continues, more and more debt will come from external sources.

One of the main things that is of concern to the banking industry is the fact that only one thing is common among motor carriers. They all have somewhat different management, different equipment, different routes, different policies, different concepts and different service, but at the same time, they have one thing in common — an operating certificate that has value and is a backup to any catastrophe that may happen from the standpoint of a going business concern

Without the value of operating certificates, banks simply will not loan money to many trucking firms, least of all those that have a weak capital base.

In the past, trucking companies have had problems and have even gone into bankruptcy. The saving grace to the lenders and to stockholders has been the operating permits and certificates of authority. They have value. And, without the value of operating certificates, banks simply will not loan money to many trucking firms, least of all those that have a weak capital base.

In our experience in the industry, we have found that regulation is a must. And, in my opinion, freedom of entry and the elimination of operating certificates in the trucking business would be a catastrophe.

Motor carriers serve many points designated by the operating certificates they own. Some of the communities they serve are small and these routes are less profitable than metropolitan markets, but motor carriers accept the obligation to serve these communities and to serve all shippers without discrimination.

If the operating rights were replaced with free entry, certificates would have no value. The motor carrier's service would be selective and not on the basis of common carrier obligation to serve. There is no doubt that this would result in poor service, bad equipment, higher shipping costs and chaos within the industry. Small communities would have to pay higher prices to attract service

The loss of service would be annoying, but would not necessarily be fatal to a community. As long as there was a demand, service would eventually be found. But, it wouldn't be as fast, as dependable or as comfortable and, unquestionably, the cost would be higher.

It probably would no longer be economical for a company to locate a manufacturing plant in a small town away from the metropolitan areas. Companies could be forced to relocate near bigger cities in order to guarantee adequate transportation services

In my opinion, transportation is one of the most important industries in this country. Without the movement of goods, the country would fail.

A manufacturing facility in New York ships to a dealer or a retailer in California. If he can't get his goods delivered, he shuts his plant down and he lays off people; if the man in California cannot receive the goods, he lays off salesmen and cannot provide the necessary products to his customers, so he fails

Truck transportation is the best bargain of the day. Practically everything we eat, wear and use is delivered by truck. Yet, the cost of shipping most products by truck is a minute fraction of the price of finished products

Without economic regulation in the trucking industry, I think you're going to see a lot more business failures, and you're going to see less profitable trucking firms and some chaotic conditions in the industry.

Banks have to rely on the operating authority as value behind the physical assets of a company. Institutional lenders would have a very negative view on lending to the trucking industry without that collateral value in the permits and certificates. Financing of motor carrier operations would be much more difficult under deregulation as proposed.

Certificates that have much value today would go like the old stock certificates during the Depression; you can hang the permit on the wall, but that's all it is — a wall fixture. ■

'belt tightening

Preston State Bank, said, "This

CITIBANK

Citibank, N.A.
399 Park Avenue
New York, NY
10043

Michael S. Fredkin
Vice President

EXHIBIT B

March 13, 1981

Honorable Kenneth L. Holland
Rayburn Office Building
Room 2431
Washington, D.C. 20515

Re: H. R. 1964

Dear Congressman:

We are pleased to submit our comments and views regarding the impact of The Motor Carrier Regulatory Reform Act of 1980 on the value of motor carrier operating rights. As a major lender to the trucking industry for the past 20 years, Citibank has followed closely those developments which have had a direct bearing on the economic status of the carriers. In our opinion, the July 1 passage of the deregulation bill marks a watershed date for the industry, particularly as it affects the interrelationship between intramodal competition and operating authorities.

Historically, government regulation of the motor carriers was premised on the need to achieve industry stability in order to provide adequate service to the shipping public. As the industry matured, regulatory perceptions also changed. The Interstate Commerce Commission epitomized the new direction, with its philosophical shift towards promoting greater competition among the carriers. During the past several years this policy was evidenced by a dramatic liberalization in the Commission's grants of and application standards for new operating rights, a trend which already diluted the value of existing authorities. The Motor Carrier Act has gone beyond such administrative initiatives by providing legislative endorsement of the Commission's "de facto" deregulation efforts and by enlarging the scope of the provisions.

In light of the foregoing developments our views on the worth of operating rights have undergone a similar conversion. Heretofore, in evaluating the credit-worthiness of trucking companies Citibank has recognized the inherent value of existing authorities. Specifically, in measuring a carrier's net worth we have not treated existing rights as intangible assets to be deducted from the equity account, provided the company historically earned a profit on these rights. However, we excluded newly-acquired authorities until the carrier demonstrated the ability to generate earnings from this authority. It should also be noted that, as a lending policy, Citibank traditionally has not made loans based on the theoretical value of a company's

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rights. Although we have financed the purchase of operating rights, contrary to many other banks' views, we have always regarded the use of authorities as loan collateral to be an indication of financial distress.

While Citibank has not made a practice of viewing operating rights as collateral per se, we have considered their value as a cushion for our traditional revenue equipment financing. Our inability to precisely quantify the market value of these assets, other than by applying various subjective measures, in part explains our Bank's reluctance to view authorities as a "bankable" asset. Nevertheless, until the advent of deregulation in the late 1970's operating rights had a number of underlying characteristics to which we could ascribe definite value: i) empirical observation indicated they had undergone tremendous appreciation over time; ii) they were readily marketable, even in distress situations; and iii) there was an active market for operating rights among trucking companies. Given these favorable qualities, Citibank over the years was willing to advance a relatively higher proportion of funds to the carriers than would otherwise have been the case. This accommodation became evident in the form of a more liberal borrowing base ratio, which is the lending formula used in equipment financing. The rationale for increasing the borrowing base ratio in our credit agreements reflected our belief that rights afforded significant, "hidden" asset protection.

The recent actions taken by the Commission and, more particularly, by Congress, as mentioned earlier, have lowered the barriers to entry and expansion in the trucking industry. Consequently, in our opinion the practical effect of these events has been to substantially eliminate the benefits and values previously associated with a carrier's rights. The resulting era of increased competition means that the carriers will no longer be able to enjoy the protection afforded by a relatively unique set of authorities. Instead, only the well-managed carriers, which demonstrate an ability to earn a reasonable rate of return under the new and changing environment, will be able to command a premium for their company.

The implications for the financial community are equally serious. By rendering motor carrier operating rights virtually worthless, the deregulation bill forces lenders to reassess their credit granting criteria with respect to the trucking industry. It, for example, no longer can be safely assumed that a carrier's rights could be sold or liquidated to help meet any operating cash shortfalls or provide funds for debt amortization. Simply stated, there are now fewer assets available to cover existing downside risks. This represents an abrupt departure from the asset protection heretofore available and will undoubtedly lead to greater selectivity on the part of lenders in extending credit.

Over the long-run Citibank firmly believes that business as a whole is better off with less government regulation. The views expressed above, however, are not intended to make a statement regarding the

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merits, pro and con, of The Motor Carrier Act. Instead, they focus on the narrow issue of whether operating rights have sustained a loss in value due to the enactment of the recent legislation. As such, we would be pleased to have this letter inserted in the record and used in connection with the upcoming hearings.

Very truly yours,

SUMMARY OF STATEMENT OF LAURENCE A. PIERCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

The pattern of economic regulation of motor carriers prevailing since 1935 has sanctioned the purchase and sale of motor carrier operating authority among carriers, subject to ICC approval in each case, as the principal means of permitting carriers to enter new market areas or withdraw from existing ones. The private enterprise response has resulted in major investment in operating authority by growth-oriented carriers and recognition of the value of operating authority by institutional investors and traditional financing sources.

The passage of the Motor Carrier Act of 1980, however, has significantly altered the established pattern of economic regulations in the motor carrier industry. In effect, the investment in motor carrier operating authority has, by government fiat, been rendered valueless. The motor carrier industry has thereby been unfavorably impacted from the standpoint of both investors and lenders, with serious consequences in certain instances.

We support the concept of some form of financial relief. Specifically, we believe that the investment in motor carrier operating authority, calculated on an aggregate adjusted basis as of July 1, 1980, should be deductible from income, for tax purposes, over a 36-month period commencing on that date or in the first month of the taxpayers' first taxable year subsequent thereto. We wish to place on the record our support for the provisions of Senate Bill 702.

THE FIRST NATIONAL BANK OF BOSTON

Laurence A. Pierce

Laurence A. Pierce
Vice President

Senator PACKWOOD. Next, we will take up the incentive stock option bill, S. 639. We have a panel consisting of Mr. W. A. Anderson, Mr. Norm Winningstad, Chairman Wilbur Mills, and Mr. Morton Collins.

I am personally happy to welcome Mr. Winningstad who I know well and who this year won the SBA award for small businessman of the year, although Floating Point Systems is not a mom and pop operation. He won the top nationwide award for his business.

Norm, welcome.

Mr. Anderson, are you going to testify first?

STATEMENTS OF WILLIAM A. ANDERSON, JR., SENIOR VICE PRESIDENT, ALASKA INTERSTATE CO., C. NORMAN WINNINGSTAD, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FLOATING POINT SYSTEMS, INC., HON. WILBUR D. MILLS, ESQ., SHEA & GOULD, AND MORTON COLLINS, PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. ANDERSON. Yes, Mr. Chairman.

My name is William A. Anderson, Jr. I am senior vice president of Alaska Interstate Co. I have a formal statement which I would like to submit for the record.

Senator PACKWOOD. The entire statements of all of the witnesses will be put in the record in full.

Mr. ANDERSON. Thank you. Now, to just briefly summarize that statement, Alaska Interstate is a 16-year old diversified energy company headquartered in Houston, Tex.

Last year we had revenues of approximately $262 million which were generated primarily through domestic and international oil and gas production and the transmission and distribution of natural gas in Alaska.

Alaska Interstate is pleased that the committee is holding this hearing on S. 639. We would like to take this opportunity to commend you and Senator Bentsen for your introduction and continued support of this bill.

The employees of Alaska Interstate Co. firmly believe that this amendment will help lose productivity and thereby reduce inflation by making it much easier for employees to obtain a proprietary interest in the company for which they work.

Significantly, the bill will accomplish this without revenue loss. One aspect of the Packwood-Bentsen bill which adds to its usefulness is the broad coverage it extends to almost all existing and new incentive stock option plans.

Alaska Interstate observes, however, that the bill's coverage is not as complete as it could be. We respectfully suggest that in order for this bill to accomplish more fully its goal of increased productivity, its coverage should be extended to all employee stock purchase plans similar in form and effect to those already included in Packwood-Bentsen.

One such similar plan is Alaska Interstate's proposed restricted stock incentive plan. Like an incentive stock option plan, Alaska Interstate's restricted stock incentive plan is aimed at providing its employees a proprietary interest in the company, thereby, giving them greater incentive to maximize work effort and increase company productivity and profitability.

In fact, our restricted stock plan probably creates a greater incentive for increased productivity than stock option plans because it gives employees an immediate proprietary interest in the company.

Under a restricted stock incentive plan, like Alaska Interstate's, a company transfers stock, instead of granting an option, to an employee for par value or an amount greater if required by State law.

The employee is then eligible to receive dividends and is entitled to voting rights. The employee, however, does not have unrestricted ownership of the stock until he or she works a specified number of years for the company. If the employee does work the appropriate number of years, the restriction lapses and the stock is owned without limitation by the employee once he pays the company an amount equal to fair market value of the stock at the time of initial transfer less the amount previously paid.

It is the tax treatment, at this point when the restrictions lapse, which Alaska Interstate believes should be at the capital gains rate that is provided under S. 639.

This favorable tax treatment would, of course, be available under a restricted stock plan only if the six qualifying requirements specified and S. 639 were observed.

Besides increasing productivity gains by granting an employee a proprietary interest in his company from the outset, coverage of restricted stock plans would result in no revenue loss to the Treasury.

The employer or corporation would not be allowed to take a business deduction for the amount includable under present law and the employee's income.

There is one additional and significant reason that restricted stock incentive plans should be covered, reduction of corporative administrative expense.

Alaska Interstate has just recently begun implementing its restricted stock plan. Implementation of that plan requires, among other things, the costly solicitation of proxies from thousands of shareholders.

If this new plan must be abandoned in favor of a qualifying plan, as permitted by Packwood-Bentsen, not only will the costs of implementing the new plan have to be borne by the company, but the cost of implementing the corporation's restricted stock plan will have been wasted.

I thank you for the time you have granted me. If you have any questions concerning my statement or the proposal, I would be happy to answer.

Senator PACKWOOD. I think we will wait until the panel has finished and then we may have questions generally.

Norm Winningstad.

Mr. WINNINGSTAD. Mr. Chairman and Senator Bensten, thank you both for introducing S. 639, as well as the efforts of last year.

My name is C. Norman Winningstad. I am chairman, president and founder of Floating Point Systems, Inc. based in Beaverton, Oreg. I am a past chairman of the Oregon Council of the American Electronics Association.

Floating Point Systems, in the last 5 years, has become a world leader in array processors; a specialized computer for solving numerically intensive problems.

We have grown from under 30 people in 1975 to over 800 employees 5 years later. In those 5 years, we grew in sales by a factor of 50 to $42 million in 1980, 26 percent of which was exported.

Our products are used in many applications, but two outstanding examples are data reduction in seismic explorations for oil, of great interest nowadays, and image-processing computed axial tomography, a breakthrough in X-ray diagnoses. The major reason for our success was that we reduced the unit cost of calculations by a factor of 10 or more, a great contribution to improved productivity.

I am appearing before you this morning on behalf of the American Electronics Association. The AEA is a trade association of more than 1,600 high technology companies in 43 States, more than one-half of these companies consisting of 200 employees or less.

FPS could not get invested venture capital prior to 1977 due to the increase in capital gains tax rate after 1969. We did get invested time and talent, however, from key employees due to the operation of the qualified stock option plan then available.

Fortunately, we had enough personal savings to solve our lack of invested capital while the company was still small, since it only cost about $12,000 in assets to employee a person in our type of small company in the high technology area.

Those key employees who contributed to the breakthrough product were rewarded appropriately through the stock option plan in those days.

We now need more key people to invest their talent. We don't have any trouble getting invested capital due to the fact that the capital gains tax rate has been substantially reduced and our company is now a success.

These heavy capital requirements are easily handled, but we now have heavy talent requirements and we want people to invest their career time in our company and we feel strongly that they should be rewarded appropriately for that effort.

I have no options of my own and in fact, I have contributed personal stock to option plans in our company. Our efforts are to improve the position of the employee investing time and talent.

We have data definitely indicating that your bill will be Treasury revenue positive. One interesting aspect of that is that our companies are actually requesting to pay more taxes. Under the present unqualified stock option plan our companies can obtain a tax deduction upon exercise of stock options.

We are, in fact, asking you to tax us. We want the benefits to accrue to the key employees who make the key contributions.

A good example that is a personal one in our company, is that we have grown to a point—$42 million a year—which has reached the experience level of our present people.

I am hiring a new president into the company to become chief operating officer. This gentleman has had experience operating in the hundreds of millions a year range. It would be very difficult to attract that gentleman of good experience to assure our continued growth and the improvement of exports and productivity, without the help of your incentive option plan.

Thank you very much.

Senator PACKWOOD. I have often thought secretly that the major large corporations of America opposed this bill because it gives the Floating Point Systems of the world a chance to steal their best engineers with stock options. They haven't come forward and done it yet, but you are absolutely right in terms of the incentive for small companies. There is nothing that is a better incentive than the stock options for bright, young talent.

Mr. MILLS. Thank you, Mr. Chairman and Senator Bentsen. I am very pleased to be with you this morning.

I would first like to take this opportunity to congratulate both of you for introducing S. 639.

I was against the favorable tax treatment of tax options in 1964 as chairman of the Ways and Means Committee because I felt they were being abused. Since then we have lowered the maximum tax rate on earned income so that it approximates corporate employer's tax rates and accordingly, I think we have virtually eliminated the tax shelter appeal of tax options.

I am impressed by your arguments that favorable tax treatment for stock options will spur productivity and be a valuable tool to encourage the growth of small businesses.

I firmly believe that if we are going to turn our present economic picture around we will have to increase productivity and encourage the growth of new businesses.

After reading your bill, I would like to suggest one amendment which would make S. 639 an even stronger bill. My suggestion is aimed at more equitable treatment for existing stock options. It is completely consistent with the bill and in fact, may make the bill more appealing.

Any time you pass a law which becomes effective immediately, you are going to affect the people who have acted and relied on the law as it was before you changed it. This problem is particularly apparent in one aspect of S. 630.

The bill, admirably, would extend the benefit of new incentive stock option treatment to already outstanding nonqualified stock options. The problem is that many of such nonqualified option plans have been modified in any number of ways adding or deleting various provisions. Most of these modifications have no tax effect whatever or had none when they were made.

However, if S. 639 becomes law, the IRS will have to consider the options as having been newly created when such modifications were made. Accordingly, a stock option that satisfies S. 639 standards in every other way probably will not qualify because the option had been modified before the new law was enacted.

The reason for this is that in order to qualify under S. 639, an option cannot have an exercise price below the fair market value of the stock on the date the option is granted.

If an option is modified, it is considered as newly granted and if the value of the stock has gone up since the option was granted, the option no longer qualifies.

S. 639 already solves the problem in one limited case: Where an existing stock option plan was modified in a particular way and affords those plans the benefit of this bill.

I think that it is a good provision except that it is not broad enough. There are many existing stock option plans that have been modified in ways other than the one mentioned in the bill and holders of these stock options should not be penalized because of modifications that were made before the new law became effective and which, at the time, had no tax significance whatsoever.

My suggestion is to add an amendment that would allow plans that have been modified prior to enactment of S. 639 to qualify as an incentive stock option provided that the option as so modified otherwise meets the requirements of an incentive stock option plan under your bill.

In this way, you achieve your objective and yet treat fairly taxpayers who have acted in reliance on current law.

I would request, Mr. Chairman, that the language of the amendment and explanation of it be included in the record with my remarks.

Thank you very much. I appreciate this opportunity.

Senator PACKWOOD. It will be.

Mr. MILLS. I may have overlooked telling you that my name is Wilbur Mills and I am representing today three clients of the firm in New York, and I have with me one of our attorneys from the New York office, Richard Halpern. We are representing Elgin National Industries, Texas Oil and Gas, and Toys R Us.

Thank you very much.

Senator PACKWOOD. My son Bill will appreciate your last client very much.

Let's take the statement from Mr. Collins.

Mr. COLLINS. Mr. Chairman and Senator Bentsen, my name is Morton Collins and I am the senior partner of DSV Associates, a $25 million partnership formed for the purpose of venture capital investing.

I am president of the National Venture Capital Association, a trade association representing most of the organized venture capital firms in the country. I am pleased to have been invited to testify here today in the exploration of solutions of the economic problems of our country.

Today, I speak on behalf of my own organization, which has made a total of 51 investments in young, high technology companies since 1968.

In addition, I speak on behalf of the National Venture Capital Association. Our organization has approximately $4.5 billion invested in small businesses. That $4.5 billion is especially critical as it constitutes the bulk of the seed capital for the technology industry of this country.

I am appearing here, today, to support the Packwood-Bentsen bill creating employee incentive stock options. This bill will provide new incentives for individual innovation, as well as an increase in Federal tax revenues.

Incentive stock options are important in enabling small companies to attract key management personnel. People leaving large companies with excellent salary and other benefits view the process of as one of investing their energies and talents in the success and growth of the small company.

These employees become partners with the financial investors and it is just as appropriate to provide capital gains treatment to them as it is to investors risking their money.

Stock options are not compensation. They are a method by which employees investing their talents, side by side with investors providing money, can receive the same benefits and enable small businesses to get started and grow.

Incentive stock options will motivate employees to find more efficient ways to perform their jobs. Such options only have value to the employee if the price of the company stock increases. Such increases generally follow increases in the company's sales and profits. This has the benefit of specifically motivating improvement and efficiency. Increased efficiency results in greater productivity and business growth creates new jobs.

Nonqualified options, granted under the current law, while better than nothing, are largely useless for inducing innovation and risk taking. The employee is forced to pay tax at ordinary rates on a phantom profit at the time of exercise of this option. He must provide that capital in real dollars to pay such taxes.

While it is possible to construct plans, generally called stock appreciation rights, by which company loans or grants are made available to enable the employee to pay taxes, they do not work in companies that have not yet reached profitability or are cash poor.

Generally, it is at this point in the development of a new company that the attraction of key management personnel is most important.

If a company is profitable, the use of stock appreciation rights can produce a significant reduction in reported earnings, distorting financial statements.

In particular, the more that good profit performance causes a company's stock price to rise, the greater will be the gain to the employee upon exercise of the nonqualified options and the greater will be the stock appreciation rights payment to the employee.

Since the stock appreciation rights payments are expenses for financial reporting purposes, the greater the profit performance, the greater the reduction of reported profit. For a small company growing rapidly, such payments can cause significant fluctuations in reported profit which will adversely affect the company's stock price. Therefore, this scheme is mostly useful to large companies with a significant base of profitability. In any case, it creates an accounting problem of substantial magnitude.

The nonqualified option plus stock appreciation right is more complex, not less complex, than an incentive stock option. A complicated incentive plan is much less effective than a simple one.

It is difficult to explain to the employee whom you are trying to motivate, a scheme under which he gets an option on which he owes ordinary income at the time of exercise, but that the company will take care of that by paying him some additional money that will cover the taxes.

That explanation lacks the simplicity of telling the same employee that he is being granted an opportunity to purchase a number of shares of the company's stock and that he will get all the benefits of ownership even though he does not have to make the cash investment until sometime in the future.

The scheme is used by employees as convoluted. Indeed, it is convoluted.

The incentive stock option proposal is a plan which benefits both business and Government. Treasury revenues are increased because corporations lose the current front-end deductions achieved with the nonqualified law.

Various groups have analyzed the effect of the incentive stock option proposal on Treasury revenues. The results of these estimates show gains in the second to third year with the magnitude of the increase reaching $30 to $60 million annually by 1985.

In conclusion, I urge you to include in the tax bill provisions for an employee incentive stock option plan. The Packwood-Bentsen bill, S. 639, contains the necessary provisions. Inclusion of this bill in a tax package will benefit both business and Government.

I thank you for your attention and would welcome your questions.

Senator PACKWOOD. I have no questions. As you are aware, we managed to get this through the Senate last year, almost got it through the Congress. I am confident we can do it. We got into a little discussion last time on issuance versus exercise. I think we have even worked that problem out in this bill to everyone's satisfaction.

I might say, Mr. Chairman, you presented an issue that we had not thought about before. We are indebted to you for bringing it to our attention.

Lloyd.

Senator BENTSEN. Well, Mr. Chairman, I am very pleased to join you in this. I start out with a bias because I was a beneficiary of the stock option before Wilbur changed his mind on the floor.

Considering the salary they were paying me, I would not have stayed if I hadn't had that stock option. It turned out to be a very fine investment.

I also experienced being a member of a board of directors that gave a substantial stock option under the current rules to the president of the company who exercised it and then through no fault of his own and because of governmental action, stock of that company took a precipitous drop. The president of that company was wiped out financially. It really is a bad approach.

Another problem we are running into, Mr. Chairman, since you had viewpoint on this. You had a great change in the managerial system of this country, you have a lot more professional managers now, you have a lot more job hoppers and you have a lot of headhunters around offering them bonuses to move to the next company. You have lost a lot of the entrepreneurial interest in companies.

So, you did the long term R. & D. and your successor is going to get credit for that. Company after company now pays a manager based on how much better he did than last year. You have too much short-term outlook in this country and that is one of the problems we have in competing with the Japanese, who take the long-term interest.

What the chairman is talking about and what I am talking about is giving them an entrepreneurial interest again, so they will hang in there and take the long term, work the market share, be the R. & D. that we need for the technological breakthroughs.

I think that this is something that is really materially going to help. I think the logic is on that side. If somebody finally makes a little money out of it, well good, I will just be delighted.

Thank you.

Senator PACKWOOD. Lloyd is right. The logic is on our side. It increases revenues. I do not, however—Mr. Chairman Mills knows this very well—I don't really expect the Treasury will endorse it just because they will gain money and logic is on our side. We do not have their commitment yet on it.

Senator BENTSEN. No, I must say that—just as you say, Mr. Chairman and Chairman Mills, that I think address date is a very valid point in this piece of legislation.

Senator PACKWOOD. Dave, any questions?

Senator DURENBERGER. No questions.

Senator PACKWOOD. Gentlemen, thank you very much.

PANEL. Thank you.

[The prepared statements of the presiding panel follows:]

STATEMENT OF

ALASKA INTERSTATE COMPANY

on

S.639: Incentive Stock Options

May 8, 1981

Mr. Chairman, my name is William A. Anderson, Jr., Senior Vice President of Alaska Interstate Company ("Alaska Interstate").

I. Alaska Interstate Company

Alaska Interstate is a sixteen year old diversified energy company, headquartered in Houston, Texas, with both domestic and foreign operations. These operations include participation in a joint venture having oil and gas activities in Indonesia, domestic oil and gas exploration and production, transmission and distribution of natural gas in Alaska, and the design, engineering, and construction of oil and gas processing facilities. In 1981, the company plans to spend over $110 million for oil and gas exploration and development, with the majority of these funds earmarked for domestic exploration and development.

II. Packwood-Bentsen In General

Alaska Interstate is pleased that the Committee is holding this hearing on S.639. We would like to take this opportunity to congratulate Senators Packwood and Bentsen for their introduction and continued support of this bill. The employees of Alaska Interstate firmly believe that this amendment will help boost productivity and thereby reduce inflation by making it much easier for employees to obtain a proprietary interest in the company for which they work. Significantly, the bill will accomplish this without revenue loss.

Under present law, compensatory stock options are generally not taxable to the recipient unless they have a readily ascertainable fair market value. The recipient is taxed, however, upon the excess of the value of the stock over the option price upon exercise. The Packwood-Bentsen incentive stock option bill would alter this current tax treatment. It would treat "incentive stock options" similarly to their treatment under this Committee's 1980 stock option proposal. If enacted, S.639 will eliminate any adverse tax consequences at the time an employee is granted an incentive stock option or exercises that option and will make an employee eligible for capital gains treatment when he sells the stock. In addition, the business expense deduction currently allowed to the employer corporation for the amount includable in the employee's income will be eliminated.

Another progressive feature of the Packwood-Bentsen proposal is its extension of favorable tax treatment not only to new incentive stock options (i.e., those granted after December 31, 1980), but to prior qualified stock options

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(within the meaning of Section 422 of the Tax Code) granted on or before December 31, 1980 which are exercised before or after that date.

The Packwood-Bentsen proposal provides equitable treatment for workers in two respects. First, by eliminating all taxation at the time an employee exercises an option to purchase stock, S.639 removes the risk to an employee under current law that he will pay a tax on unrealized "profits" which disappear when the value of the purchased stock declines. Second, by treating new and existing stock option plans alike, Packwood-Bentsen will prevent employees from changing jobs merely to obtain coverage under plans offering capital gains treatment.

III. The Need To Include Restricted Stock Incentive Plans

One aspect of the Packwood-Bentsen bill which adds to its usefulness and effectiveness is the broad coverage it extends to almost all existing and new incentive stock option plans. Alaska Interstate observes, however, that the bill's coverage is not as complete as it could be. We respectfully suggest that in order for the bill to accomplish more fully its goal of increased productivity, its coverage should be extended to all employee stock purchase plans similar in form and effect to those already included in Packwood-Bentsen. One such similar plan is Alaska Interstate's proposed restricted stock incentive plan.

Like an incentive stock option plan, Alaska Interstate's restricted stock incentive plan is aimed at providing its employees a proprietary interest in the company, thereby giving them greater incentive to maximize work effort and increase company productivity and profitability. In fact, our restricted stock plan probably creates a greater incentive for increased productivity than stock option plans because it gives employees an immediate proprietary interest in the company.

Under a restricted stock incentive plan like Alaska Interstate's, a company transfers stock, instead of granting an option, to an employee for par value (or a greater amount if required by state law). The employee is then eligible to receive dividends and is entitled to voting rights. The employee, however, does not have unrestricted ownership of the stock until he or she works a specified number of years for the company. If the employee does work the appropriate number of years, the "restriction" lapses and the stock is owned without limitations by the employee once he pays the company an amount equal to the fair market value of the stock at the time of initial transfer. (This amount would be reduced, of course, by the par value or other amount paid initially.) It is the tax treatment at this point which Alaska Interstate believes should be similar to that provided under S.639. This favorable tax treatment would, of course, be available under a restricted stock plan only if the six qualifying requirements specified in S.639 were observed.

Besides increasing productivity gains by granting an employee a proprietary interest in his company from the outset, coverage of restricted stock plans would result in no revenue loss to the Treasury. The employer corporation would not be allowed to take a business deduction for the amount includable under present law in the employee's income.

There is one additional and significant reason that restricted stock incentive plans should be covered: reduction of corporate administrative expense. Alaska Interstate has just recently begun implementing its restricted stock plan. Implementation of that plan requires, among other things, the costly solicitation of proxies from thousands of shareholders. If this new plan must be abandoned in favor of a qualifying plan (as permitted by Packwood-Bentsen), not only will the costs of implementing the new, conforming plan have to be borne by the company, but the cost of implementing the corporation's restricted stock plan will have been wasted. This waste we believe would violate the spirit of equity and flexibility which characterizes S.639 as well as reduce the productivity gains which Packwood-Bentsen fosters.

Conclusion

Mr. Chairman, I want to briefly repeat the reasons why Alaska Interstate believes restricted stock plans should be covered under Packwood-Bentsen:

First, from an economic standpoint, an incentive stock option plan under Packwood-Bentsen is substantially equivalent to a restricted stock plan like Alaska Interstate's.

Second, the only significant difference between the plans is that with restricted stock an employee gets at the outset a proprietary interest in his company. This will enhance the incentive for increased productivity.

Third, the exclusion of existing restricted stock plans from the benefits of S.639 will needlessly increase the costs of administering employee incentive programs.

Fourth, the inclusion of restricted stock plans will result in no net revenue loss.

Alaska Interstate believes that the spirit of S.639 will be well served by including among the plans covered by the bill other employee incentive stock plans, such as Alaska Interstate's employee incentive restricted stock plan, which are aimed at maximizing employee work effort and increasing employee productivity. Significantly, inclusion of these plans would not result in the violation of any of the six qualifying rules specified in Packwood-Bentsen.

Thank you for the time you have granted me. If you have any questions concerning my statement or proposal, I will try to answer them.

Statement of

C. Norman Winningstad
Chairman and President of
Floating Point Systems, Incorporated

before the

Subcommittee on Taxation & Debt Management
Senate Committee on Finance

May 8, 1981

Summary of Points in Support of S. 639

Restoration of the Restricted Stock Option would:

- Promote productivity growth;
- Help small, growing companies attract talented employees;
- Eliminate the unfair tax treatment of the current (non-qualified) options; and
- Increase federal tax revenues.

Existing options, as well as those granted in the future should be covered.

AEA American Electronics Association
1612 K Street, N.W., Washington, D.C. 20006

STATEMENT OF C. NORMAN WINNINGSTAD, CHAIRMAN, PRESIDENT & FOUNDER FLOATING POINT SYSTEMS, INC. ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION

Before the Subcommittee on Taxation and Debt Management Senate Committee on Finance

May 8, 1981

Mr. Chairman and Members of this distinguished Subcommittee.

My name is C. Norman Winningstad. I am Chairman, President, and founder of Floating Point Systems, Incorporated, based in Beaverton, Oregon. I am past chairman of the Oregon Council of the American Electronics Association, and the U.S. Small Business Administration's 1981 Oregon Small Businessman of the Year.

Floating Point Systems (FPS) in the last five years has become a world leader in Array Processors, a specialized computer for solving numerically intensive problems (it comes as a surpise to most people that 90% of computer sales are for business-oriented computers, which are very efficient in creating and manipulating files, as opposed to "number crunching".) We have grown from under 30 people in 1975 to over 800 employees five years later. In those five years, we grew sales by a factor of 50, to $42 million in 1980, 26% of which was exported. Our products are used in many applications, but two outstanding examples are data reduction in seismic exploration for oil, and image processing in Computed Axial Tomography (a breakthrough in x-ray diagnoses). The major reason for our success was that we reduced the unit costs of calculations by a factor of 10 or more.

I am appearing before you this morning representing the American Electronics Association. AEA is a trade association of more than 1,600 high-technology companies in 43 states. Our members are manufacturers of electronic components and equipment or suppliers of products and services in the information processing industries. While our member companies employe more than one million Americans and include some of the nation's largest companies, more than half of our member companies are small business employing fewer than 200 people.

Mr. Chairman, the high-technology companies of the American Electronics Association strongly support passage of your and Senator Bentsen's bill, S.639. I am here today to explain why. S.639 would amend the Internal Revenue Code to restore stock options as a viable form of employee incentive compensation. The capital gains-tax reduction encouraged investors of capital who make it possible to create jobs. But there is another "investor" who has been left out. This is the person who invests his career time and talent in a company, instead of money. A reinstitution of "restricted stock options" (referred to as "incentive options" in S.639) would improve the ability of those companies to attract and motivate the personnel they need to survive and grow.

In the last Congress, attempts were made to restore this valuable tool for innovation. A majority of the House Ways and Means Committee sponsored a bill introduced by Congressman Jones and Frenzel to restore the pre-1964 tax treatment of employee stock options, and the Senate Finance Committee passed your version of the bill by a 19-1 vote. The House bill this year is H.R.2797 again sponsored by Congressmen Jones and Frenzel.

We believe that the case for restoring restricted stock options is unusually strong. Restricted stock options would:

- o Promote productivity growth;
- o Help small, growing companies attract talented employees;
- o Eliminate the unfair tax treatment of the current (non-qualified) options; and
- o Increase federal tax revenues.

I shall describe briefly each of these positive effects.

RESTRICTED STOCK OPTIONS WOULD PROMOTE PRODUCTIVITY GROWTH

Historically the American high-technology industries have been world leaders, contributing significant export sales to this nation's trade balance and, by their products, permitting advances in U.S. productivity. However, the United States today still lags behind most industrialized nations in productivity growth. Although the main cause appears to be inadequate savings and investment in this country, a major secondary factor may be lack of motivation on the part of American employees to make the kinds of effort and take the risks needed for American industry to keep pace with our competitors abroad.

Granting restricted stock options would motivate employees to do a better job and find better ways to do the job. A stock option only has value to the employee if the price of the company's stock increases through growth in its sales and profits. Therefore, options give employees a strong incentive to find ways to expand the company's business and conduct that business more efficiently. Business growth creates more new jobs. Increased efficiency results in greater productivity.

In addition, based on the experience of my own company and those of my colleagues in the electronics industry, I want to point out a more subtle, attitudinal effect that granting stock options can have on a company's workforce. The effect is difficult to quantify, but not hard to describe: it is that dramatic difference between how people act when they are employees versus how they act when they are also the owners. It is the extra effort people expend to achieve goals and get the job done when they have a stake in the company. The basic point is that no one tends to someone else's business as well as he manages his own.

Normally, few employees would have the capital needed to become significant owners in the companies that employ them, but restricted stock options can give them the opportunity for the benefits of ownership without their having to make the up-front cash outlay.

Instead of cash, they invest their time, careers, and talents.

RESTRICTED STOCK OPTIONS WOULD HELP SMALL, GROWING COMPANIES ATTRACT TALENTED EMPLOYEES.

Businesses of all sizes would benefit from restoring restricted stock options. We would expect large companies which seek to improve their employees' motivation to welcome this change wholeheartedly. However, the greatest benefit would flow to small businesses. In fact, the White House Conference on Small Business, to which I was a delegate earlier this year, endorsed the restoration of favorable tax treatment of stock options as one of its key recommendations to promote innovation in small businesses.

Restoring restricted stock options would substantially reduce the total cost of founding a new company. When you think about the long lead time it usually takes before a new company can begin shipping its first product, you can see that any form of compensation that reduces the "up front" cash outlay during that priod can be extremely valuable. That is precisely what restricted stock options can accomplish. The employees who are granted the options ultimately receive compensation in the form of increased stock value (if the venture is successful), but the company pays out no cash. Instead, the cost of compensation from restricted stock options is borne indirectly by the existing shareholders through dilution in value of their shares. However, the shareholders desire this because they, in turn, can anticipate increased appreciation in the value of their shares in the company due to the increased productivity of the employees.

Restricted stock options would also give smaller, growing companies a means of attracting talented employees away from secure jobs in larger companies. Because the value of stock options depend on growth in value of a company's shares, the stock price of smaller companies can usually rise, on a percentage basis, far faster than that of established companies. Thus, options are proportionately more rewarding for small business employees than for employees of larger companies. Smaller corporations can ill afford to pay the salaries necessary to compete with Fortune 500 companies for talented employees, but they can partially offset that disadvantage with stock options.

Most high-technology companies in the American Electronics Association are based upon the clever ideas of key employees across many disciplines. Clearly, they should be rewarded for their contributions to the success of their company. FPS has pursued this policy by granting stock options since its beginning in 1970. I believe this incentive was a key factor in the willingness of our engineering staff to work long hours, under the difficult conditions of primitive resources, during the Array Processor's gestation period in late 1974 and early 1975. Stock options made "tigers" our of our early marketing managers in 1976 and 1977 when we quadrupled sales in both years. They also inspired our manufacturing people as they transformed us from a job-shop producing less than one Array Processor per week to a production house turning out four per day.

RESTRICTED STOCK OPTIONS WOULD ELIMINATE THE UNFAIR TAX TREATMENT OF CURRENT (NON-QUALIFIED) STOCK OPTIONS.

Restoring restricted stock options would create an attractive alternative to today's so-called "non-qualified" otpions, which are practically useless to many growing companies. Under the present law, when an employee exercises these non-qualified options, he must pay taxes--at ordinary income tax rates--on the "paper profit" between his option price and the price of the stock when he buys it.

Not only is taxation at ordinary income rates inconsistent with what other owners would pay on their capital appreciation, but, in addition, the employee must pay the tax before he actually realizes the gain from selling the stock. It's analogous to taxing the appreciation on a homeowner's house each year even though he doesn't sell it. Employees without reserves of funds may not be able to buy the stock and also pay the tax on a "paper profit."

Furthermore, they are often prevented from selling the stock immediately to generate such funds because their companies may be privately held or, if the stock is publicly held, because of insider trading regulations imposed by the securities laws. The prospect of getting into such a financial squeeze is hardly an incentive for outstanding performance.

In other instances, today's law results in gross and unintended hardship. For example, if the value of the stock purchased through an option should decline, and after that the employee needs to sell it, the employee not only takes a loss on the stock, but he has also paid taxes at ordinary income rates on a "gain" he never realized. This is not just a theoretical possibility. It has happened often enough in the last few years to destroy any usefulness employee stock options may have had for companies in volatile industries.

As a company like ours grows jobs and exports and provides its customers with increased productivity, we need to hire one key employee for roughly every 10 regular employees. Under the present tax treatment of employee stock options we place that key employee under great financial, and hence mental, strain, precisely when he should be concerned only with the success of the company.

Under the provisions of S.639, the employee would pay no tax until he finally sells the stock purchased under the option. Then he would pay a capital gains tax. The company would receive no deduction--but neither would it fear the imposition of unconscionable financial burdens on employees it had intended to motivate and reward.

RESTRICTED OPTIONS WILL INCREASE FEDERAL TAX REVENUES

The final and most compelling reason this bill should be passed is that it will not cost the Treasury a dime. It will actually raise more revenue than the current demotivating tax treatment of stock options.

In 1976, Congress was told that phasing out the qualified stock option would increase Treasury revenue. However, that change actually deprived industry of an extremely useful form of incentive compensation that was not deductible from corporate taxes and forced companies to substitute other forms of compensation that are deductible. Greater deductions from the same taxable income has actually resulted in lower corporate tax payments to the Treasury.

Both cash compensation and non-qualified stock options generate employee taxes to the Treasury. However, this revenue is more than offset when the corporation deducts them as business expenses from its own taxes. On the other hand, employee compensation in the form of restricted stock options would not be deductible to the corporation. Therefore, to the extent that these more attractive options replace cash and non-qualified options, corporate tax payments will increase.

I am attaching an analysis of this bill done by the public accounting firm of Price Waterhouse and Company which confirms the positive revenue effect of this bill and indicates that, in most cases, the government is losing money under the current law.

The Joint Committee on Taxation has also examined the revenue impact of this bill. A copy of their analysis is also attached. In it, the Joint Committee estimates that after an initial adjustment period which should cost less than $10 million total, S.639 would raise $15 million in Fiscal Year 1984 and $30 million in 1985. This is a net revenue gain of $35 million in six years.

We agree with the general conclusion of this analysis, but we think its estimate of the positive revenue flow is much too low. Since most companies desiring to use options would gladly use restricted stock options rather than non-qualified options which are not as effective as incentives, we believe one good indication of the revenue that could be gained from this bill is the amount of deductions companies now take for their non-qualified options.

In preparing for this testimony, AEA contacted 10 of its member companies and asked them to report their non-qualified option deductions for the last five years to the public accounting firm of Coopers and Lybrand. Coopers and Lybrand informs us that between 1975 and 1979 these companies deducted more than $68 million from their taxes due to non-qualified option realizations. At the current corporate tax rate of 46%, that represents over $31 million fewer tax dollars to the Treasury than these companies would have paid if these had been restricted stock options. Of course, if these had been restricted stock options, the employees would not have paid ordinary income taxes--which would have almost exactly offset the increase in corporate taxes. However, if these had been restricted stock options (at an ansumed average capital gains tax rate of 20%) the employees would have to pay $13.6 million of capital gains taxes on the $68 million of realizations. Therefore, the $13.6 million would approximate the net revenue increase to the Treasury if restricted stock options could have been used by just these ten electronics companies. Since there are hundreds of other companies which would use restricted option programs if they could, we think it is fair to expect that over a period of time as restricted stock option plans are adopted throughout the economy, there will be a positive net revenue flow to the Treasury far larger than the current official estimate for this bill.

<u>Mr. Chairman, we are asking you to let us pay higher taxes</u>. You may not hear that too often. But we are willing, even happy to, because we believe restricted stock options are substantially more attractive to our employees than equivalent cash or non-qualified option compensation.

I should point out that passage of this bill will not require companies to pay higher taxes. Only those companies which, with the approval of shareholders, choose to adopt a restricted stock option plan would pay more.

EXISTING STOCK OPTIONS SHOULD BE COVERED IN THIS FIELD

Mr. Chairman, as I mentioned, your bill on this subject passed the Senate Finance Committee in the last Congress. Though it was drafted differently, it would have accomplished almost exactly the same thing as the House bill. During the mark up, though, the Finance Committee added a provision which we believe made a substantial improvement in the bill. We are pleased you have retained it this year, and hope you will keep it in conference with the House, if that becomes necessary. I am referring to the way the bill would treat existing stock options.

This year's House bill H.R. 2797 would only apply to options granted after its effective date, while your bill would apply to outstanding options which are exercised after enactment. Briefly, there are four strong reasons to prefer the Senate version:

First, it would immediately end the inequity that results when people who exercise options and purchase shares have to pay tax, at ordinary income rates, on whatever increase there has been-- even though they have actually realized no income. If the value of the stock then declines, as often happens, these people are stuck, having paid tax on a "profit" that subsequently vanished. This risk of loss on pre-paid taxes, when added to the risk of loss on the stock itself,has seriously diminished the incentive value of stock options. Making the bill effective for options exercised after enactment would prevent this inequity for all outstanding options.

Second, if the bill defers that taxable event only for options granted after enactment, it will seriously dilute the value of all existing option plans and could contribute to an undesirable spate of job-hopping in our industry and others. We are quite willing to suffer such an effect if that is the price for reforming stock options. But it could easily be avoided by covering the exercise of existing stock options in the bill.

The third important reason to make this change is that it will further increase Treasury's revenue gain and begin that process immediately. Companies which elect to convert their existing options to restricted stock options would give up the off-setting deduction they now receive when the employee buys the stock and pays the tax.

Finally, covering existing options will allow more restricted stock options to be granted. Since most companies maintain a ceiling on the number of outstanding shares dedicated to options, an incentive to cash in the old ones would speed the process of converting to the new improved version. Conversely, if the slower moving old options were left out of the bills, it would limit the number of new restricted options which the companies could grant.

Extending this bill to existing options would substantilly improve its value to our industry. We hope you will do so, but let us be clear that our highest priority is enacting the substance of this bill.

***

Mr. Chairman, we hope you and your colleagues in the Senate will pass this bill again this year, and send it to the House If you do, it is likely to receive a very positive welcome there, since a majority of the Ways and Means Committee members co-sponsored the House version in the last Congress.

I sincerely appreciate this opportunity to participate in your crowded docket of witnesses. Thank you.

Attachments

Price Waterhouse & Co.

OFFICE OF GOVERNMENT SERVICES
1801 K STREET, N.W
WASHINGTON, D.C. 20006
202-296-0800

October 26, 1979

Mr. Herbert M. Dwight
Chairman
Financial Incentives Task Force
American Electronics Association
1612 K Street, N.W.
Washington, D.C. 20006

Dear Mr. Dwight:

You have asked us to comment on certain tax aspects of proposed legislation introduced in the House of Representatives by Congressman James R. Jones of Oklahoma. The specific proposal on which you have asked us to comment is H. R. 5060, referred to as the "Employees Incentive Ownership Act of 1979". This proposal would amend Internal Revenue Code Section 424 to reinstate treatment given to Restricted Stock Options prior to 1964. The proposal would also amend Internal Revenue Code Section 57 to exclude restricted stock options from the definition of tax preference items.

In general, the proposal would result in deferring income recognition to an employee recipient, who exercises a restricted stock option, until such time as the stock is sold, rather than at the time the option is exercised. Assuming the option price is at least 95 percent of the fair market value of the stock at the date of grant, and the employee holds the stock for at least one year following exercise of the option, the employee may realize a capital gain on the entire gain attributable to stock acquired by option. Current rules provide that the employee will realize ordinary income on stock acquired by option to the extent the fair market value exceeds the option price at the date of exercise. The option granting employer would not receive a deduction for any value of the shares acquired under the proposed option in excess of the option price.

The deferral of the income recognition under the proposed legislation can be particularly attractive to the employee. Under these rules, the employee would not face the requirement of making potentially significant tax payments when the event giving rise to the tax liability (exercise of the option) has yielded no cash. This provision can be especially important in view of the cash payment necessary to exercise the option. The possible application of capital gain rates, rather than ordinary income tax rates provides additional potential advantage to the employee.

In our capacity as professional accountants, we are not in a position to estimate total revenue impact (including timing of collection) of the proposal to the Treasury of the United States. Neither are we in a position to state whether this proposal is preferable to other incentive compensation arrangements. However, we can state that, depending on the circumstances, the proposed legislation may have a positive effect on revenue collections to the extent restricted stock options are substituted for non qualified options or cash compensation. The latter point may be illustrated by the following explanation. Under the current law, a corporate employer is allowed a tax deduction for an amount equal to the ordinary income an employee recognizes upon the exercise of stock option. Under the proposal the corporate employer would not receive a tax deduction. Thus assuming an individual is in the top earned income bracket of 50 percent and the corporate employer is in the top 46 percent bracket, the Treasury is in a position to collect only a maximum of 4 percent of the difference between the option price and the fair market value at date of exercise. Under the proposals of H. R. 5060 the gain could ultimately be taxed at rates up to 28 percent, assuming the stock maintains a value at least equal to the value at the date of exercise. Consideration of appreciation in value after exercise is not relevant since it would be subject to the same rules under the existing and proposed law.

The elimination of the corporate tax deduction is the key feature which, depending on the marginal rate of the taxpayer, could cause Treasury collections to increase. For example, assume an option for 100 shares at $10 per share is exercised when the stock is selling for $15 per share, and the stock is sold one-year later without either depreciation or further appreciation. Assume further that the individual employee is in the top tax bracket of 70 percent and the employer is in the highest corporate bracket of 46 percent. The tax collections are as follows:

Proposed Law	Tax Due
Employee's capital gain tax ($1,500 - $1,000) X 28%*	$140
Ordinary income tax to the employee	- o -
Ordinary tax reduction for the employer	- o -
Net revenue under the proposal	140
Current Law	
Ordinary income tax to employee ($1,500 - $1,000) X 50%**	$250
Ordinary tax reduction for employer ($1,500 - $1,000) X 46%	(230)
Net revenue under current law	20
Increase of revenue under this proposed law	$120

*Maximum capital gain tax rate (100% - 60%) X 70%

**Maximum rate on earned i[illegible]

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This example reflects an employee and employer in the highest tax brackets. Obviously the effect on Treasury revenues is a function of the employee's and employer's marginal tax brackets. The effect on revenue can be more dramatic if the corporation is in the maximum tax bracket of 46 percent and the employee is in a relatively low rate bracket.

A schedule which details tax collections using various individual marginal tax brackets, assuming marginal corporate tax rates of 46 percent and 26.75 percent, is attached to this letter. The previously stated example and an illustration of a 46 percent rate corporate and a relatively low tax rate employee are included in the schedule. A review of this schedule makes it clear that net revenues to the Treasury are negative under the current rules relating to stock options to the extent the marginal tax rate of the option granting employer exceeds the marginal tax rate of the employee. The converse is true to the extent marginal tax rates of the employee exceed those of the corporation.

Using the assumed facts, the schedule also indicates that the proposed legislation would result in net revenues to the Treasury in each transaction, whereas the present law can result in a net revenue loss to the Treasury in many instances. In fact, the proposed legislation results in increased revenue over that which exists in each example under current law provided that the marginal corporate tax rate is 46 percent. The present law provides revenue in excess of the proposed legislation in only two examples assuming the marginal corporate tax rate is 26.75 percent. The rate of this occurrence increases as the marginal corporate tax rates decrease from 26.75 percent to zero.

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Tax revenues under the proposed legislation would decrease below the level reflected on the attached schedule if the price of the stock decreased following exercise of the option, prior to the date of sale. If the value of the stock fell to the option price prior to sale, the revenue would be eliminated.

The proposal to eliminate restricted stock options from the definition of tax preference items should not have a significant negative effect on revenue as currently projected. This is attributable to the fact that additional restricted stock options can not be granted under the law as it currently exists, and all presently outstanding restricted stock options must be exercised by May 21, 1981.

In summary, "The Employees Incentive Ownership Act of 1979" appears to offer the combination of reducing individual tax burdens for the employee and potentially increasing Treasury collections.

Yours very truly,

Peter J. Hart
National Director of Tax Policy
Price Waterhouse & Co.

ATTACHMENT TO LETTER OF OCTOBER 26, 1979

ILLUSTRATION OF EFFECT OF H. R. 5060 ON TREASURY REVENUE IN GIVEN INDIVIDUAL SITUATIONS

Assumptions

A. Fair market values at the date of exercise exceeds the option price by $500.

B. Corporate tax rate is either 46 percent or 26.75 percent (the maximum corporate rate is 46 percent, while the effective rate on the first $100,000 of corporate taxable income is 26.75 percent).

Summary

Individual Marginal Tax Bracket-- Joint Returns	Treasury--Revenue <Expenditure>		
	Current Law		
	Corporate Rate of		H. R. 5060 Proposal [2]
	46%	26.75%	
70%	$20.00 [1]	$116.25 [1]	$140.00
68%	20.00 [1]	116.25 [1]	136.00
64%	20.00 [1]	116.25 [1]	128.00
59%	20.00 [1]	116.25 [1]	118.00
54%	20.00 [1]	116.25 [1]	108.00
49%	15.00	111.25	98.00
43%	<15.00>	81.25	86.00
37%	<45.00>	51.25	74.00
32%	<70.00>	26.25	64.00
28%	<90.00>	6.25	56.00
24%	<110.00>	<13.75>	48.00
21%	<125.00>	<28.75>	42.00

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Individual Marginal Tax Bracket--Joint Returns	Treasury--Revenue <Expenditure> Current Law Corporate Rate of 46%	26.75%	H. R. 5060 Proposal (2)
18%	<140.00>	<43.75>	36.00
16%	<150.00>	<53.75>	32.00
14%	<160.00>	<63.75>	28.00

(1) Reflects the 50 percent maximum tax rate on earned income.

(2) It should be noted that collections are delayed until the recipient disposes of the option stock.

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OCT 25 1979

Honorable Bill Frenzel
House of Representatives
Washington, D.C. 20515

Dear Mr. Frenzel:

This is in response to a letter from Dave Rosenauer of your staff regarding the revenue impact of H.R. 5060, a bill which would permit the use of restricted stock options while removing the exercise of such options as an item of tax preference. As you know, the Tax Reform Act of 1976 required that a restricted stock option as defined in Section 424(b) of the Internal Revenue Code be exercised before May 21, 1981 or be subject to the same tax treatment accorded nonstatutory options under Section 83. If enacted, H.R. 5060, would continue to allow the issuance of this type of preferred compensation under a more favorable tax arrangement.

Introducing a new and presumably more preferred instrument of executive compensation raises the possibility of some shifting in the make-up of the compensation package, making it difficult to assess the potential revenue impact. We are convinced, however, that although such restructuring is inevitable, the net effect on budget receipts in the near future will be negligible. Speculation on the long-term revenue impact of H.R. 5060 depends invariably on the vagaries of the stock market, and could be misleading. Nevertheless, elimination of the restricted stock option as an item of tax preference at time of exercise, and the failure to treat this gain as ordinary income does result in a positive net revenue effect. This is due principally to the fact that the granting corporation is no longer allowed a deduction for compensation paid.

Accordingly, should H.R. 5060 become law for taxable years beginning after December 31, 1979 the effect on budget receipts for fiscal years 1980-1983 will be an annual net reduction of less than $2.5 million. This short-term anomaly is a result of the substitution in compensation elements induced by the bill. In years subsequent, when the inevitable disposition of the restricted stock results in its being treated as a long-term capital gain, we estimate the concomitant increase in net revenues to be $15 million in fiscal year 1984 and $30 million in fiscal 1985.

Sincerely yours,

B. S.

Bernard M. Shapiro

STATEMENT

WILBUR D. MILLS

Shea & Gould

Washington, D. C.

May 8, 1981

Good Morning. I would first like to take this opportunity to congratulate Senators Packwood and Bentsen on introducing S. 639. I was against the favorable tax treatment of stock options in 1964 because I felt they were being abused. It was a tax shelter, pure and simple. But since then, we've lowered the maximum tax rate on earned income so that it approximates corporate employers' tax rates and accordingly we have virtually eliminated the tax shelter appeal of stock options.

I am impressed by your arguments that favorable tax treatment for stock options will spur productivity and be a valuable tool to encourage the growth of small businesses. I firmly believe that if we are going to turn our present economic picture around, we will have to increase productivity and encourage the growth of new businesses.

After reading your bill, I would like to suggest one amendment which would make S. 639 an even stronger bill. My suggestion is aimed at more equitable treatment for existing stock options, is completely consistent with S. 639 and, in fact, may make S.639 even more appealing.

Any time you pass a law which becomes effective immediately, you are going to affect the people who have acted and relied on the law as it was before you changed it. This problem is particularly apparent in one aspect of S. 639. The bill, admirably, would extend the benefit of new incentive stock option treatment to already outstanding nonqualified stock options.

The problem is that many of such nonqualified option plans have been modified in any number of ways, adding or deleting various provisions. Most of these modifications had no tax effect whatever when they were made. However, if S. 639 becomes law, the IRS will have to consider the options as having been newly created when such modifications were made. Accordingly, a stock option which satisfies S. 639's standards in every other way probably will not qualify because the option had been modified before the new law was enacted. The reason for this is that in order to qualify under S. 639, an option cannot have an exercise price below the fair market value of the stock on the date the option is granted. If an option is modified, it is considered as newly granted and if the value of the stock has gone up since the option was granted, the option no longer qualifies.

S. 639 already solves the problem in one limited case where an existing stock option plan was modified in a particular way and affords those plans the benefits of this bill. I think that is a good provision except that it is not broad enough. There are many existing stock option plans that have been modified in ways other than the one mentioned in the bill and holders of these stock options should not be penalized because of modifications that were made before the new law became effective and which at the time had no tax significance whatever.

My suggestion is to add an amendment that would allow plans that have been modified prior to enactment of S. 639 to qualify as an incentive stock option, provided, that the option as so modified otherwise meets the requirements of an incentive stock option. In this way you achieve your objective and yet treat fairly taxpayers who have acted in reliance on current law.

I would request that the actual language of my suggested amendment be made part of the Record. Thank you.

SUGGESTED AMENDMENT

It is suggested that proposed paragraph (b) of "Section 2. Effective Dates and Transitional Rules" of Senate Bill 639 be changed to read as follows:

> "(b) In the case of an option granted before January 1, 1982, paragraph (1) of section 425(h) of such Code shall not apply:
>
> (1) to any change in the terms of such option made before not more than 6 months after the date of enactment of this Act to permit the plan to modify or delete a stock appreciation right or other rights to cash payments concurrent with exercise of the options; and
>
> (2) to any modification in the terms of such option made before the date of enactment of this Act which would otherwise result in disqualifying such option as an incentive stock option by reason of the application of such paragraph (1) of section 425(h), provided that the option as so modified otherwise meets the requirements of an incentive stock option."

NATIONAL VENTURE CAPITAL ASSOCIATION
1225 19th Street, N.W., Suite 750
Washington, D.C. 20036
(202) 659-5756

STATEMENT OF

MORTON COLLINS

General Partner
DSV ASSOCIATES

and

President
NATIONAL VENTURE CAPITAL ASSOCIATION

before the

UNITED STATES SENATE
FINANCE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

Friday, May 8, 1981

SUMMARY OF TESTIMONY

MORTON COLLINS
NATIONAL VENTURE CAPITAL ASSOCIATION

1. Employee Incentive Stock Options are extremely important in enabling small companies to attract critically needed key management personnel.

2. Stock options are not compensation; they are a method by which employees investing their talents side by side with investors providing money can receive the same benefits and enable small businesses to get started and grow.

3. Stock options will motivate employees to find more efficient ways to perform their jobs. Increased efficiency results in greater productivity. The resulting business growth creates new jobs.

4. Non-qualified options, available under current law, are often combined with Stock Appreciation Rights to yield results for the employee similar to those which would be obtained with Incentive Stock Options. Such programs do not work in young companies when key management personnel are most needed.

5. The Employee Incentive Stock Option proposal will increase Treasury revenues by an amount estimated to aggregate $30 - $60 million annually by 1985.

STATEMENT OF
MORTON COLLINS
GENERAL PARTNER, DSV ASSOCIATES
PRESIDENT OF THE NATIONAL VENTURE CAPITAL ASSOCIATION
BEFORE THE
FINANCE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
May 8, 1981

Mr. Chairman and Members of this Distinguished Committee:

My name is Morton Collins and I am a General Partner of DSV Associates, which is a $25 million Limited Partnership formed in 1974 for the purpose of venture capital investing. Prior to the formation of DSV Associates, I was Chief Executive Officer of Data Science Ventures, Incorporated, a privately held corporation formed in 1968 for the purpose of venture capital investing. Since 1975, I have been a Director of the National Venture Capital Association, a trade association representing most of the organized venture capital firms in the country, and I am currently President of this Association.

Prior to initiating my career in venture capital, I was the founder and Chief Executive Officer of a computer services company and before that I was a faculty member in the School of Engineering at Princeton University.

Finance Subcommittee on Taxation
and Debt Management
Page -2-
May 8, 1981

I am pleased to have been invited to testify here today and I thank the Committee for this opportunity to further explore solutions to the economic problems of the country. Today, I speak on behalf of my own organization, DSV Associates, which when combined with its predecessor has made a total of 51 investments in young high technology companies since 1968. Our sole objective is to provide equity funding and sophisticated management and technical assistance primarily to new, high risk, growth oriented companies. In addition, I speak on behalf of the National Venture Capital Association. The NVCA's membership consists of 105 firms throughout the country which in the aggregate have approximately $4.5 billion invested in small businesses. That $4.5 billion is especially critical as it constitutes the seed capital for the technology industry of this country.

My organization is representative of the venture capital industry as a whole in what it does. While the principal focus tends to be on high technology, often more mundane areas of business are financed by the venture industry. An example of such a company is Federal Express. Federal Express, financed by the venture capital industry has beat the United Parcel Service and the U.S. Postal Service at their own game by provided a service the marketplace needed.

Finance Subcommittee on Taxation
and Debt Management
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May 8, 1981

I am appearing here today to urge you to include in the tax package a provision creating Employee Incentive Stock Options. This provision will provide new incentives for individual innovation as well as an increase in Federal tax revenues.

Incentive Stock Options are important in enabling small companies to attract key management personnel. Such a stock option gives the employee the right to buy shares in the company at the current price for a fixed period of time and to obtain capital gains tax treatment on any gain realized from later sale of the shares after the shares have been held for a prescribed period. People leaving large companies with excellent salary and other benefits view the process as one of investing their energies and talents in the success and growth of the small company. These employees become "partners" with the financial investors and it's just as appropriate to offer capital gains treatment to them as it is to investors risking their money. Stock options are not compensation; they are a method by which employees investing their talents side by side with investors providing money can receive the same benefits and enable small businesses to get started and grow.

82-820 O—81——9

Incentive Stock Options will motivate employees to find more efficient ways to perform their jobs. Such options only have value to the employee if the price of the company's stock increases. Such increases generally follow increases in the company's sales and profits. This has the benefit of specifically motivating improvement in efficiency. Increased efficiency results in greater productivity and business growth creates new jobs.

"Non-qualified" options, granted under the current law, while better than nothing, are largely useless for inducing innovation and risk taking. The employee is forced to pay tax at ordinary rates on a "phantom" profit at the time of exercise of his option. He must provide the capital in "real" dollars to pay such taxes. While it is possible to construct plans, generally called Stock Appreciation Rights, by which company loans or grants are made available to enable the employee to pay taxes, they do not work in companies that have not yet reached profitability or are cash poor. Generally, it is at this point in the development of a new company that the attraction of key management personnel is most important. If a company is profitable, the use of Stock Appreciation Rights can produce a significant reduction in reported earnings distorting financial statements. In particular, the more that good profit performance causes a company's stock price to rise, the greater will be the gain to the employee upon exercise of the non-qualified options and the greater will be the Stock Appreciation Rights payment to the employee. Since the Stock Appreciation Rights payments are expenses for financial reporting purposes, the greater the profit performance, the greater the reduction of reported profit. For a small company growing rapidly, such payments can cause significant fluctuations in reported profit which will adversely affect the company's stock price. Therefore, this scheme is mostly useful to large companies with a significant base of profitablility. In any case, it creates an accounting problem of substantial magnitude.

The non-qualified option plus Stock Appreciation Rights is more complex, not less complex than an Incentive Stock Option. A complicated incentive plan is much less effective than a simple one. It's difficult to explain to the employee whom you are trying to motivate a scheme under which he gets an option on which he owes ordinary income at the time of exercise, but that the company will take care of that by paying him some additional money that will cover the taxes. That explanation lacks the simplicity of telling the same employee that he is being granted an opportunity to purchase a number of shares of the company's stock and he will get all the benefits of ownership even though he does not have to make the cash investment until some time in the future. The qualified option program is simple, straightforward and effective, while the other scheme is viewed by employees as convoluted. Indeed, it is convoluted.

The Incentive Stock Option proposal is a plan which benefits both business and government. Treasury revenues are increased because corporations lose the current front-end deductions achieved with the non-qualified option law. Various groups have analyzed the effect of the Incentive Stock Option proposal on Treasury revenue. The results of these estimates show gains in the second to third year, with the magnitude of the increase reaching $30 - $60 million annually by 1985.

In conclusion, I urge you to include in the tax bill provisions for an Employee Incentive Stock Option Plan. The Packwood-Bentson Bill, S.639 contains the necessary provisions. Inclusion of this bill in the tax package will benefit both business and government.

I thank you for your attention and would welcome your questions.

Senator PACKWOOD. We will wait just a moment for the room to clear out and then we will take up S. 738, the St. Paul Port Authority revenue bonds issue.

We have a panel consisting of Mr. Kraut, Mr. Wellington, and Mr. Preeshl.

Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman. I thank you for the opportunity to present S. 738 along with two other bills which I am supporting, one of which I am a cosponsor, S. 702, because of the impact that you probably did not perceive but you now know it's having on motor carriers in this country.

S. 738 is a measure designed to allow the Port Authority of the city of St. Paul to advance refund prior to issues of revenue bonds. Such refundings will relieve the port authority of restrictive covenants, improve its cash flow, and strengthen the port authority's ability to finance future projects.

St. Paul Port Authority revenue bonds are unique because, unlike typical investor revenue bonds, the port authority bonds are secured by a pledge of almost all of the port authority's revenue derived from facilities owned by the port authority but leased by private companies.

This so-called full security has allowed the port authority to finance many projects which could not attract private finance when standing alone.

To market the bonds, however, the port authority had to enter into many restrictive covenants which have impacted on the entire operation of the authority and its ability to issue bonds in the future.

The most serious restriction is the requirement that an additional reserve fund be maintained as additional security for the port authority's so-called full security bond. Although the additional reserve fund was needed over 5 years ago when the port authority initially made the bonds available, the requirement is no longer necessary for the marketing of the bonds because of the proven success of the program.

The upshot is that major revenues to the port authority are being trapped in this additional reserve fund rather than used to help fund the port authority's economic development program which is essential to the city of St. Paul.

The problem is that refunding the prior issues is the only practical remedy the port authority has of relieving itself of restrictive covenants no longer required by existing market conditions.

The remedy, however, is not available to the port authority because of the fact the interest on such refunding bonds would not be exempt from Federal income taxation under the existing provisions of section 103B of the Internal Revenue Code.

This bill, S. 738, would resolve that problem. The proposed refunding amendment 103B also allows the port authority to improve its cash flow by requiring that any debt service savings gained by the refunding accrue for the benefit of the port authority rather than be passed on to private companies due to facilities financed by the bonds being refunded.

This requirement further enhances the ability of the port authority to finance future bond issues backed by a pledge of revenues derived from port authority facilities.

In short, the proposed refunding amendment solves the problem of the St. Paul Port Authority and because of the narrow scope of the amendment, would not impact throughout the rest of the country.

For this reason, I submit that that Internal Revenue Service should have no objections to this amendment. The three people—I guess there are four people now on the panel, three of them you have introduced. Gene Kraut, who is the assistant executive vice president of the port authority. Steve Wellington, who is director of development for the city of St. Paul and Warren Preeshl, who is vice president of Miller & Schroeder Municipals based in Minneapolis but with offices in other parts of this country.

The fourth person is an old friend, as all these people are, Peter Seed. I see Esq. after his name. I don't know what that means, but that may only be because I know him too well. He is the bond council to the port authority and I recommend their testimony to you, Mr. Chairman.

Senator PACKWOOD. Gentlemen, welcome.

STATEMENTS OF EUGENE A. KRAUT, ASSISTANT EXECUTIVE VICE PRESIDENT, PORT AUTHORITY OF THE CITY OF ST. PAUL, MINN., STEVE WELLINGTON, DIRECTOR OF DEVELOPMENT, DEPARTMENT OF PLANNING AND ECONOMIC DEVELOPMENT, CITY OF ST. PAUL, AND F. WARREN PREESHL, VICE PRESIDENT, MILLER & SCHROEDER MUNICIPALS, INC.

Mr. KRAUT. Mr. Chairman and Senator Durenberger, my name is Eugene Kraut and I am assistant executive vice president of the St. Paul Port Authority.

St. Paul Authority issued its first industrial revenue bond in 1966. It has issued approximately $400 million worth of various types of revenue bonds since, $144 million of which are issued as parity lien bonds under Port Authority Resolution 876. They are the bonds which we hope we will be allowed to refund if Senator Durenberger's bill is acted upon.

We recently commenced a study by Midwest Research Institute to determine what the port authority's impact and its financing program have on the city of St. Paul.

The figures are nothing short of astounding for a community with a population of 265,000 persons. We have retained a greater percentage of our manufacturing jobs than Minneapolis, Duluth, Omaha, Kansas City, Des Moines, and Milwaukee.

We have increased our total jobs by a larger number and a greater percentage than either of these communities, As of December 31, 1980, we had created or saved 16,640 direct jobs. The multiplier effect of these jobs is a total number of 31,500.

Of the total economic base, based upon sales and value added in 1980 of $8.6 billion, $6 billion for St. Paul, our activities primarily through a sophisticated revenue bond financing program accounted for $2.5 billion or 29 percent.

In short, for every dollar circulating from sales or value added in St. Paul's economy, nearly 30 cents was a direct result of port authority activities.

Now, we are embarked on our biggest project ever. We currently own and operate seven industrial parks in St. Paul and are in the process of creating St. Paul Energy Park. It is a project created by a partnership of the Federal Government, the State of Minnesota, and the city of St. Paul through the negotiated investment strategy process which emanated from the Department of Housing and Urban Development as a result of studies by the Rand Corp. and the Kettering Foundation as an experiment in Federal, State, and municipal cooperation.

The project involves a reclamation of 200 acres of underutilized railroad and industrial reuse property. It is being developed at a cost of $44 million, approximately $14 million of which will be port authority funds.

The project will, when complete, employ 4,800 people, contain 950 multiple family housing units, both rental and owner occupied, and be an international example of energy conservation.

The ability to refund our outstanding parity lien bonds will release unnecessarily impacted cash and cash flow to facilitate the development of this unique and outstanding project.

While this project would develop with our assistance and that of the Federal Government, without the ability to refund our parity lien bonds, it would by the same token, impact our ability to do other necessary projects in our city.

I have attached an analysis of existing fund balances which illustrate those funds which would be released, that is, the additional reserve fund and the cash flow by refunding.

Until recently, the port authority did not use Federal funds in any manner, other than the tax exemption granted industrial revenue bonds.

In our case, the $2.5 billion generated would, in my opinion, be a substantial return on investment to the State and Federal Governments for that tax exemption. We are now involved in numerous UDAG grants where our bonding capacity and our "A" rating, which we utilize on these projects at the request of the city, are the only reason that we fulfill the developments for which the grants or loans have been made. It is to further improve this ability that we request your consideration of S. 738.

Thank you.

Senator PACKWOOD. Thank you. Mr. Wellington.

Mr. WELLINGTON. Thank you, Mr. Chairman. My name is Steven Wellington, deputy director for development for the city's department of planning and economic development. I am here on behalf of Mayor George Latimer.

The city of St. Paul is an older, northern city that is fully developed with limited available land for economic development. The city shows some of the signs of economic stress exhibited by many of the cities in the northern tier.

We have experienced 14-percent population loss in the last decade. Many manufacturing jobs have relocated to suburban and southern areas. A substantial portion of our housing stock is in need of rehabilitation and many of our industrial and commercial facilities are in need of redevelopment.

The city's response to this set of circumstances has been an ambitious and successful economic development program. After a number of years of economic in the early and mid-1970's, the city's efforts to attract new industrial, commercial and housing investment have paid off dramatically.

In the past 4 years, running, over $200 million in new building permits have been issued each year in the city for a combined total of close to $1 billion of new investment.

This is in contrast to previous annual figures of approximately $100-$120 million annually. In the downtown area alone, nearly $300 million in new investment is currently underway or just completed.

We have been able to attract more than $30 million in urban development action grants from the Department of Housing and Urban Development for eight major redevelopment projects.

Our ability to turn around our local economy in the face of larger demographic and market forces which are admittedly working against us, is due in no small measure to the activities of the St. Paul Port Authority.

As Mr. Kraut has indicated in his statement to the committee, the port authority's track record in attracting employment and investment is outstanding.

Their unique form of revenue bond financing which relies on a sophisticated form of reserve funds and guarantees, has enabled us to raise capital, in many cases where without such a vehicle, investment simply would not have taken place.

The port authority's success has enabled the city's economic development department to bring the port authority's resources to bear on a number of complicated and quite expensive redevelopment projects.

Whereas 10 years ago the port authority was primarily restricted to more traditional industrial park development, today, its activities encompass the full range of commercial and industrial development and redevelopment throughout the city.

Such important projects as Energy Park, which has been previously mentioned, would simply be impossible without the financial resources the port authority can bring to bear.

Senator Durenberger's bill would substantially expand the ability of the port authority to assist the city in its economic development activities.

While the provisions of the bill may seem somewhat unrelated to our direct economic development program, from the city's standpoint, passage of this legislation would quite simply mean an additional $20 to $25 million estimated in funds available over a 10-year period, being available for local redevelopment activities.

This financial resource is critical to many future projects as yet only in the planning stages. Such local resources, particularly when viewed in the context of apparent reductions in Federal grant funds for economic development activities make passage of the legislation quite important to the future economic viability of the city.

Mayor George Latimer and the members of the St. Paul City Council have indicated to me their strong support for congressional assistance in this area.

I would urge this committee's positive action of the Durenberger legislation so that the city can continue in its efforts at locally initiated economic revitalization.

Thank you, very much.

Senator PACKWOOD. Thank you. Mr. Preeshl.

Mr. PREESHL. Mr. Chairman, Senator Durenberger. I am Warren Preeshl, vice president of Miller & Schroeder Municipals, Inc., which is a municipal bond underwriting firm based in St. Paul-Minneapolis with offices in Chicago and LaJolla, Calif.

I participated with Mr. Kraut in structuring the initial financing concept in 1974 whereby the various bond issues all were combined into a pool of revenues such that each bond issue supported the other. As we discussed the concept with the rating agencies, we made it quite conservative because it was a new concept. One of the conservative techniques was to have not only a reserve fund, but an additional reserve fund.

As the port authority has grown and as the financial pool has increased, it now has about 70 companies involved with approximately $144 million worth of bonds outstanding. The additional reserve security device is no longer needed and is acting to unnecessarily trap revenues that otherwise could be used by the port authority for additional development.

The issuance of revenue bonds puts into effect a contract between the bondholder and the issuer whereby the terms of those bond issues established by the bond indenture cannot be changed without the bondholders consent.

There are hundreds of bondholders now and it is just not possible to go and get their consent. The needed technique, then, is to issue a new master bond issue of approximately $100 million, the proceeds of which would be invested in U.S. Treasury obligations, made specifically available for the purpose as "State and local government series" which effectively defeases the outstanding bonds and those bondholders would no longer have a right to an additional reserve.

The new bond issue would be serviced, as is the present one, by the rental income derived from the tenants. With luck, we would expect the new debt service to be less than the old so that there will be additional cash flow coming to the port authority from the refunding as well as a release of the money presently in the additional reserve.

With a refunding, under the permission granted by S. 738, the Treasury arbitrage regulations regarding the reinvestment of bond proceeds, would still be complied with, of course.

Thank you very much.

Senator PACKWOOD. We congratulate all of you on the apparent success that you have had with these bonds and the regrowth of the St. Paul area. I am somewhat familiar with some of the northern tier cities' problems and this program is very unique. You gentleman are entitled to congratulations.

Dave.

Senator DURENBERGER. Thank you, Mr. Chairman. Thank you for your recognition of the uniqueness of a community that I get used to expecting unique things from, but it is a compliment to hear your recognition of that.

Warren, to your knowledge is there any other entity anywhere in the country that has a problem similar to the one we are trying to address with S. 738?

Mr. PREESHL. To my knowledge there is no other entity that operates as the port authority does with the pooling of a whole series of industrial revenue bonds. There are other entities that are authorities operating docks, wards, airports, and so forth. Some of these authorities had a problem with the 1977 IRS regulations. Peter Seed, bond counsel, knows more about this than I do, but they were essentially assisted by the 1978 tax bill which said it is OK fellows for you to do something, but the bill didn't apply to the port authority because of its unique structure.

Senator PACKWOOD. Peter, maybe I could ask you to expand on the exemptions to the arbitrage regulations that Warren spoke of. If you could, would you expand, both on what the IRS regulations did in 1977 and then what was done in 1978 as far as certain airports and authorities were concerned.

Mr. SEED. I would be happy to, Mr. Chairman. I am Peter Seed and serve as bond counsel for the Port Authority of St. Paul and for the city of St. Paul.

Fundamentally, what is at stake here is a fairness issue. The program that has been described to you was one that was put together in February of 1974.

One of the reasons that the port authority felt secure in putting together such a program, even though it would be merging securities and therefore be required to make covenants that would affect its future operations, was the expectation, which was very real and justified under then existing law, that if some of these restrictive covenants proved to be unnecessary in the future there was a mechanism under existing law at that time to advance refund and be discharged of those kinds of obligations.

It was not until 1977 that the Treasury promulgated prospective regulations which had the effect of eliminating this remedy, this fall-back fail-safe remedy that was available to the port authority.

Subsequent to 1977 it became clear that we were unnecessarily trapping great amounts of revenues, including a reserve of in excess of $3.5 million and a cash flow in excess of $650,000 a year. When it became clear that these restrictions were no longer needed, there was nothing that the port authority could do. It was caught by a subsequent regulation.

What the port authority is asking for, here, is some relief for a unique program that would solely impact upon the port authority and the proposed legislation was designed so that the impact would not be far reaching because we appreciate that Treasury may have some objection if it were not narrowly circumscribed.

Senator PACKWOOD. Thank you very much. I have no questions. Gentlemen, your problem is unique.

Dave, thank you for bringing it up.

[The prepared statements of the preceding panel follows:]

[Hearing adjourned at 10:45 a.m.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Testimony of Eugene A. Kraut
Assistant Executive Vice President of
Port Authority of the City of Saint Paul
25 W. 4th St., St. Paul, Minnesota
Before

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
Friday, May 8, 1981, 9:30 a.m.
Room 221, Dirksen Senate Office Building
Washington, D. C.

The St. Paul Port Authority issued its first industrial revenue bond in 1966. It has issued approximately $400 million worth of various types of revenue bonds since, $144 million of which are issued as parity lien bonds under Port Authority Resolution 876, which are the bonds which we hope we will be allowed to refund if Senator Durenberger's bill is acted upon.

We recently commenced a study by Midwest Research Institute to determine what the Port Authority's impact and its financing program has been on the city of St. Paul. The figures are nothing short of astounding for a community with a population of 265,000 persons.

We have retained a greater percentage of our manufacturing jobs than Minneapolis, Duluth, Omaha, Kansa City, Des Moines, and Milwaukee. We have increased our total jobs by a larger number and a greater percentage than either of these communities. As of December 31, 1980, we had created or saved 16,640 direct jobs, the multiplier effect of these jobs results in a total number of 31,500.

Of the total economic base based upon sales and value added in 1980 of $816 billion, our activities primarily through our sophisticated revenue bond financing program accounted for $2.5 billion of the total or 29%. In short, for every dollar circulating from sales or value added in St. Paul's economy nearly 30¢ was a direct result of the Port Authority's activites.

Now we are embarked on our biggest project ever. We currently own and operate seven industrial parks in St. Paul and are in the process of creating St. Paul Energy Park, which is a project created by a partnership of the federal government, the state of Minnesota, and the city of St. Paul, through the Negotiated Investment Strategy process, which emanated from the Department of Housing and Urban Development as a result of studies by the Rand Corporation and the Kettering Foundation as an experiment in federal, state and municipal cooperation.

This project involves the reclamation of 200 acres of under-utilized railroad and industrial re-use property and is being developed at a cost of $44 million, approximately $14 million of which will be Port Authority funds.

The project will, when complete, employ 4,800 people, contain 950 multiple family housing units (both rental and owner-occupied) and be an international example of energy conservation.

The ability to refund our outstanding parity lien bonds will release unnecessarily impacted cash and cash flow to facilitate the development of this unique and outstanding project. While this project would develop with our assistance and that of the federal government, without the ability to refund our parity lien bonds it would by the same token impact our ability to do other necessary projects in our city.

I have attached an analysis of the existing fund balances which illustrate those funds which would be released, i.e., the additional reserve fund and the cash flow by refunding.

Until recently the Port Authority did not utilize federal funds in any manner other than the tax exemption granted industrial revenue bonds. In our case the $2-1/2 billion generated would, in my opinion, be a substantial return on investment to the state and federal governments for that tax exemption. We are now involved in numerous UDAG grants where our bonding capacity and our 'A' rating, which we utilize on these projects at the request of the city, are the only reason that we fulfill the developments for which the grants or loans have been made. It is to further improve this ability that we request your consideration of S.F. 738.

PORT AUTHORITY OF THE CITY OF SAINT PAUL

After the closing of a $1,450,000 issue (Series 1981-C) the statistics with regard to bonds issued under the Port Authorities general guarantee plan (Basic Resolution #876, as amended) are as follows:

Total Bonds Issued (125 issues)	$375,230,000
Bonds Outstanding (all party lien)	144,260,000
1981 lease rental income	9,982,791
1981 debt service	8,967,197
Maximum lease rental income (1985)	14,585,499
Maximum debt service (1986)	14,508,943
Reserve fund (5-5-81)	14,547,691
Additional Reserve fund (12-31-80)	3,173,174

Note 1. Certain facilities' rental is not included (See Page 9 of the Official Statement), but rental income is expected. In addition, some $2,800,000 per year of additional lease income and interest income is available, as shown below.

The Port Authority develops, as income, the following items, as roughly predicted for the calendar year of 1981:

1.	Income from non-revenue bond facilities (in 1980) $	774,467
2.	Interest income on the sinking fund float $9,982,791 @ 3% (3 month average life)	299,484
3.	Interest income on the Reserve Fund Assume 10% of $14,547,691 (this rate allows for certain reserves escrowed by the tenant).	1,454.769
4.	Interest income on the Additional Reserve Assume 10% on $3,173,174	317,317
	Total income in excess of debt service (without allowance for excess lease rental income in certain years, e.g. 1981)	2,846,037 (2)

Note 2. Of this 75% of items 2 and 3 above goes directly to the Additional Reserve ($224,613 + $1,091,076 = $1,315,689). The remaining $1,530,348 will be added to the retained earnings of the Port Authority (termed Accumulated Net Revenues) and used for operating expenses, land acquisition, debt service on G.O. bonds, etc.

These simplified 1981 estimates will change during the year, but the actual figures will be precisely determined by the 1981 CPA audit.

Testimony of Stephen B. Wellington
Deputy Director for Development
Department of Planning and Economic Development
City of Saint Paul
25 W. 4th St., Saint Paul, Minnesota

On behalf of Mayor George Latimer
Before

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
Friday, Jay 8, 1981, 9:30 a.m.
Room 2221 Dirksen Senate Office Building
Washington, D. C.

The City of Saint Paul is an older northern city that is fully developed with limited available land for economic development. The city shows some of the signs of economic stress exhibited by many of the cities in the northern tier. We have experienced 14 percent population loss in the last decade. Many manufacturing jobs have relocated to suburban and southern areas. A substantial portion of our housing stock is in need of rehabilitation and many of our industrial and commercial facilities are in need of redevelopment.

The city's response to this set of circumstances has been an ambitious and successful economic development program. After a number of years of economic stagnation in the early and mid-'70s, the city's efforts to attract new industrial, commercial and housing investment have paid off dramatically. In the past four years running over $200 million in new building permits have been issued each year for a combined total of close to a billion dollars in new investment. This is in contrast to previous annual figures approximately $100-$120 million. In the downtown area alone, nearly $300 million in new investment is currently under way or just completed. We have been able to attract more than $30 million in Urban Development Action Grants from the Department of Housing and Urban Development for eight major redevelopment projects.

Our ability to turn around our local economy in the face of larger demographic and market forces which are admittedly working against us is due in no small measure to the activities of the St. Paul Port Authority. As Mr. Kraut has indicated in his statement to the committee, the Port Authority's track record in attracting employment and investment is outstanding. Their unique form of revenue bond financing which relies on a sophisticated form of reserve funds and guarantees, has enabled us to raise capital in many cases where without such a vehicle investment simply would not have taken place.

The Port Authority's success has enabled the city's Economic Development Department to bring the Port Authority's resources to bear on a number of complicated and expensive redevelopment activities. Whereas ten years ago the Port Authority was primarily restricted to more traditional industrial park development, today its activities encompass the full range of commercial and industrial development and redevelopment throughout the city. Such important redevelopment projects as Energy Park, which has been previously mentioned, would simply be impossible without the financial resources the Port Authority can bring to bear.

Senator Durenberger's bill would substantially expand the ability of the Port Authority to assist the city in its economic development activities. While the provisions of the bill may seem somewhat complicated, from the city's standpoint passage of this legislation would most likely mean an additional $20-$25 million in funds over a ten year period being available for redevelopment activities throughout the city. This financial resource is critical to many future projects as yet only in the planning stages. Such local resources, particularly when viewed in the context of apparent reductions in federal grant funds for economic development activities make passage of the legislation quite important to the future economic viability of the city.

82-820 O—81——10

Mayor George Latimer and the members of the Saint Paul City Council have indicated to me their strong support for congressional assistance in this area. I would urge this committee's positive action on the Durenberger legislation so that the city can continue in its efforts at locally initiated economic revitalization.

Testimony of F. Warren Preeshl
Vice President of
Miller & Schroeder Municipals, Inc.
7900 Xerxes Avenue South
Minneapolis, Minnesota 55431
Before

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
Friday, May 8, 1981, 9:30 a.m.
Room 221, Dirksen Senate Office Building
Washington, D.C.

My name is Warren Preeshl and I am Vice President of Miller & Schroeder Municipals, Inc., a municipal bond underwriting firm located in the Twin Cities of St. Paul and Minneapolis. My firm, and myself in particular, has been associated with the Port Authority of the City of Saint Paul since the middle 1960's. We presently manage an underwriting group, comprised of most of the municipal bond dealers in Minneapolis and St. Paul, which stands ready to underwrite the revenue bonds of the Port Authority whether they be very small issues or very large issues, our duty and opportunity being to provide financing for the projects that the Port Authority deems advisable to undertake.

The financing structure that the Port Authority has developed is, to my knowledge, unique in the country in that it essentially pools each forthcoming issue of industrial revenue bonds into the previously existing pool of bonds, issuing the new bonds on a parity lien basis so that all projects as a group help to support any one project. The result of this pooling concept has been that both large and small companies can be financed. The efficiency of the financing is very great with a part of the benefits of this efficiency being passed on to the prospective tenant in the form of favorable interest rates on long-term financing and a part of the benefit being used to develop a stream of income to the Port Authority in excess of that required to service the debt. With this financing concept, any particular project can go into default insofar as its lease payments to the Port Authority are concerned but the ongoing stream of revenues supports the bonds issued to finance the project until such time as the project has been re-leased to a new tenant. This financing concept was first placed into effect in 1974 and approximately $34,000,000 of bonds were placed into this financing pool in the initial financing done in the years 1974, 1975, and 1976. Since this was a relatively new concept, a "belt and suspenders" security device was established whereby all available revenues were pledged to the Common Reserve Fund from which all revenue bonds are serviced. A Reserve was established, and is required in each subsequent bond issue, equal to the maximum annual principal and interest requirement. An Additional Reserve Fund was established as a backstop to the basic reserve. This Additional Reserve Fund now is approximately $3,700,000 of being annually increased by a pledge of 75% of the interest earnings on the Common Revenue Bond Fund which approximates $750,000 a year.

The Port Authority has been actively seeking additional land within the City limits of St. Paul to acquire for commercial and industrial purposes. To the extent it is able to acquire this land from its own cash resources, the need for long-term borrowing for this purpose is of course eliminated.

The proposed legislation recognizes that it is necessary to refund and defease the presently outstanding revenue bonds secured in the above manner so that the restrictive indenture provisions can be eliminated and the Additional Reserve Fund transferred to the land acquisition account of the Port Authority and so that the revenues presently "trapped" in the continuing build-up of the Additional Reserve Fund can be released to the ongoing operations of the Port Authority.

At the present time there are approximately $144,000,000 of revenue bonds outstanding under this pool concept of which a minimum of approximately $100,000,000 would need to be defeased in order to achieve the desired purpose of the Port Authority. The method of doing this, of course, is to issue a new $100,000,000 bond issue, depositing the proceeds with a trustee to be invested in the U.S. Treasury obligations under the existing arbitrage limitations so as to pay the outstanding bonds out of the principal and interest from the U.S. Treasury obligations and service the new bonds (absent the Additional Reserve Fund requirement) out of the ongoing revenues of the Port Authority. We would hope, of course, that it might be possible to refund these bonds in such a way that the new debt service will be less than the present debt service, thereby enhancing the cash flow of the Port Authority, inasmuch as it is not the practice of the Port Authority to reduce rents to tenants, retaining instead all advantages to itself, so that the excess funds, if any, will be available for additional development within the City limits of St. Paul.

We have distributed copies *of the official statement whereby issues of the Port Authority are sold to the public, the latest issue being for $1,450,000, designated Series 1981-C. This is the usual offering document for industrial revenue bonds and shows on the first page the way the bonds mature and the interest rates the investors may receive depending on the maturity of the bond purchased. Information inside demonstrates the cash flow of the Port Authority and its fund balances. Appendix A at the back is a list of tenants whose lease payments pay debt service on the bonds that are presently outstanding. Appendix B is a much smaller list of tenants who are paying rent to the Port Authority for one reason or another, principally fleeting and land rental, but whose facilities were not financed by revenue bonds. The sum of the rents available under Appendices A and B, together with interest earnings on the various funds of the Port Authority, constitutes the source of income to the Port

Authority from which it pays debt service on its outstanding bonds, pays its operating expenses and adds each year to its available land.

The Port Authority of the City of Saint Paul is unique in my experience in the small size of its staff, the rapid response of the staff to make an opportunity to develop jobs and tax base for the City, and the rapport which it maintains with all of its tenants so that one of the best sources of referrals is satisfied tenants of the Port Authority.

We would appreciate your consideration of this Senate File No. 738 which if passed into law, will allow the Port Authority to remove the unnecessary indenture restrictions and thereby develop a greater cash flow for reinvestment in the economic growth of the City of Saint Paul.

FWP/cay

5/8/81

* The above named document was made part of the official committee files.

SUBMITTED STATEMENT BY THE
AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS
TO THE SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE ON
INCENTIVE STOCK OPTIONS ---- S. 639

May 22, 1981

The AFL-CIO is opposed to S. 639. The measure, would overturn a significant tax reform made in 1976 to curb a widespread and much abused tax avoidance scheme for high paid executives.

The so-called "incentive" stock option proposal is nothing more than a reinstitution of the pre-1976 "Qualified" Stock Option loophole which permitted executives to both postpone and avoid taxes by taking "options" to buy their company's stock in lieu of salary. Under this bill, the value of the option would not be considered taxable income when received. No tax would have to be paid when the executive exercised the option; and, as long as the stock was purchased within 10 years of receipt of the option, no tax would be owed at the time of the actual purchase of the stock regardless of its value and the profit. The income would be taxable only if and when the stock is sold and then the profit would be treated as a "Capital Gains." That is, 60% of the profit would be tax free and only 40% would be included as taxable income.

Ironically, reinstituting this loophole is advocated as an "incentive to innovation and risk taking." Yet, it is strictly a one-way street although the executive has much to gain through deferring taxes and converting what should be fully taxable compensation into preferentially taxed capital gains; no risk of loss is involved. If the value of the stock should fall, the executive simply does not exercise his option.

The device was also used, in the past, as a lure to executives to jump from firm to firm leading, in our view, to a diminution of commitment, managerial productivity and efficiency.

We should also note that the 50% maximum tax that now applies on an earned income was basically enacted as a quid pro quo for closing the qualified stock option loophole. The Treasury, last fall, testifying on a similar measure stated "it is important to note that the 50 percent maximum rate of tax on earned income was enacted in 1976 primarily to reduce the time and effort expended by executives on complicated and unusual fringe benefits and 'tax loopholes,' such as tax-qualified options, at the expense of normal business operations."

Lastly, the device also enables corporations to obscure -- from the public as well as its own shareholders -- the actual level and value of compensation paid to executives.

We, therefore, urge rejection of S. 639.

STATEMENT OF

BAKER INTERNATIONAL CORPORATION

ON

S.639, INCENTIVE STOCK OPTIONS

BEFORE

THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF

THE SENATE FINANCE COMMITTEE

Baker International Corporation appreciates the opportunity to submit this statement in support of S.639, legislation which would amend the Internal Revenue Code with respect to the income tax treatment of incentive employee stock options. We believe that this legislation is urgently needed to promote our country's capital formation and long range productivity, and we respectfully urge that its provisions be incorporated in this year's major tax proposal.

Baker International Corporation, with more than 23,000 employees throughout this nation and the world, serves the petroleum and mining industries by manufacturing and marketing a wide range of products and performing services utilized in the extraction, recovery, and processing of oil, gas, and other minerals. In 1964, Baker developed and implemented an employee stock option plan as a device to promote long range productivity by its key employees. Since 1968 we have granted options once a year to our key employees, with more than 312 such employees receiving option awards on the most recent option grant date.

Our experience with stock options at Bakér has demonstrated that option awards are the most efficient device for the promotion of long range productivity by our key employees. In contrast to cash bonuses which focus on short one year goals, options give an employee an incentive to look beyond the immediate year and to develop long range business plans vital to our company's growth. Because of this, Baker has chosen the option award as the principal compensatory device for the promotion of the company's growth. The company has no "phantom" options or similar arrangements.

While our stock option plan has assisted us in our efforts to attract and maintain highly motivated key employees, we believe that the incentive plan has been severely hampered by the federal tax treatment of these plans under current law. Presently, our employees are taxed at ordinary rates on the value of the stock option (i.e., the difference between the value of the stock and the option price) at the time the option is exercised. Typically, the employee wants to retain the stock he acquires, and we want him to continue his interest in that stock, but unless he has substantial capital resources, he must presently sell about three-fourths of the stock received upon option exercise in order to pay the taxes and exercise price (assume the stock price is twice the grant price and a fifty percent tax). We have found that being a holder of our company's stock is a powerful productivity motivator for our key employees. The present tax treatment works to reduce the number of shares they can hold and therefore sharply reduces the productivity motivation. S.639 will enhance that motivation.

It is possible for a corporation to adopt a parallel Stock Appreciation Rights ("SAR") program whereby the corporation loans or grants the employee sufficient funds to pay the taxes. This is a complex arrangement, not easily explainable to employees or shareholders. Furthermore, the SAR exercise itself would result in even more taxes at ordinary rates to the participating employee. Thus, the SAR is an awkward method of compensating for deficiencies in the taxation of stock options.

Requiring our employees to pay cash taxes at ordinary rates on a "profit" which they have never realized is both inconsistent with the treatment of other capital appreciation and is a substantial deterrent to the use of the most efficient and direct employee motivation device our company has at its disposal. We feel at Baker that one of the major causes of this corporation's rapid growth in revenues and earnings is its highly motivated key employees, and that stock options have played a vital part in that motivation.

S.639, the Packwood-Bentsen Incentive Stock Option bill, would eliminate these inequities and at the same time institute a tax policy designed to spur economic growth and capital formation. Under S.639, employees who participate in such plans would not be required to pay cash taxes until they actually receive cash from sale of the stock and then such tax would be at capital gains rates, which is more consistent with the long-term values we are striving to implant in our key employees. At the same time, corporations, such as Baker, would no longer be permitted to take the currently allowable business expense deduction with respect to the incentive stock option. Baker stands ready and willing to suffer this tax deduction "loss" because we appreciate the substantial motivation increase which would accrue to us as a result of these options.

We are particularly supportive of the provisions within S.639 which would extend this tax treatment to existing non-qualified stock options if they meet the incentive stock option test. If this legislation is to achieve its economic and productivity objectives, these provisions must be retained. Many of Baker's existing options do not expire for a number of years. The productivity motivation of employees holding these options will be keenly enhanced by the provisions of S.639.

We support the purpose of S.639 and urge that the clarifications suggested by Wilbur D. Mills before the Subcommittee on May 8, 1981, be incorporated into the Bill in order to treat fairly holders of presently unexercised options.

In a year in which Congress is attempting to return this nation to fiscal responsibility, every effort should be made to develop tax proposals which stimulate investment and productivity. S.639 is such a proposal. Enactment of this legislation covering existing and future stock options is urgently needed if corporations are to provide their employees with meaningful incentives to achieve business growth and expansion. We commend the Senate Finance Committee for including an incentive stock option proposal in its version of the Tax Reduction Act of 1980, and we urge that any tax package reported by this Committee incorporate the provisions of S.639 and the foregoing clarifications.

STATEMENT OF A. M. BODFORD
COLONIAL MOTOR FREIGHT LINE, INC.
TO COMMITTEE ON FINANCE
U. S. SENATE

May 8, 1981

My name is Al Bodford. I am Vice President of Colonial Motor Freight Line, Inc. of High Point, North Carolina. My company transports general commodities and furniture between Maryland, Virginia, North Carolina, South Carolina, Georgia, Tennessee and the District of Columbia. We have annual gross revenue of about $13 million.

I thank you, Mr. Chairman and members of the Committee, for the opportunity to share our thoughts concerning the tax aspects of President Reagan's economic program, specifically concerning an aspect of great importance to the Motor Carrier Industry and Colonial Motor Freight Line, Inc. The purpose of this testimony is to discuss the necessity of a proposed income tax deduction relating to the effect of the Motor Carrier Act of 1980 on carrier operating rights.

The American Trucking Association, Inc. (ATA) has made an excellent case for the necessity of tax relief for the Motor Carrier Industry. We agree that legislation is needed, but we disagree with the method presented in S-702. We think a formula should be used in allowing for tax relief that is fair and equitable to all motor carriers, not just the one's which have acquired operating rights through exorbitant purchase prices in recent years. Hindsight is 20-20, but it certainly shows that many companies made bad decisions in recent years to acquire operating rights, whereas, other companies such as Colonial nurtured and developed the authority granted by the ICC many years ago. Will the proposed tax legislation give inequitable tax relief to companies which made bad decisions? We think so! Two identical segments of operating authority between certain points had identical values on July 1, 1980 when the Motor Carrier Act of

1980 made these rights virtually worthless. Shouldn't the tax relief be identical, fair and consistent for the owners of that identical authority? We think so. Simply because one company bought authority and another company applied for and acquired the authority through the ICC many years ago does not mean that the tax relief should be different. We want an equitable, consistent, fair formula which will recognize the economic loss of both companies on a consistent basis. Exhibit A reflects one such formula based on operating revenue. This formula relates the loss in value of operating rights to revenue and would afford one consistent approach. There are other possible formulas. We are not so concerned about the formula as we are about the fairness and consistency involved. S-702 as now written is discriminatory and should be modified to eliminate this unfair feature. Operating rights are operating rights and should be treated as one and the same.

Mr. Chairman, had Colonial Motor Freight Line, Inc. sold and bought and resold and rebought it's very same operating rights over the year's, we would be looking at a large unjustified tax deduction as proposed in S-702. Colonial has been operating within the same family over the last forty years. The owner's have not milked the company of it's assets and have tried to abide by the then "rules of the game." Colonial is now being discriminated against in favor of companies which have gone out and bought often time bankrupt companies operating rights. We strongly encourage that equity be considered in S-702 to eliminate the now existing discriminatory aspects of that bill. Legislation is indeed necessary to compensate carriers for the real loss in value sustained by the enactment of the Motor Carrier Act of 1980. During committee consideration of the legislation, equitable legislation should be built into S-702 by using a fair, consistent method for determining the tax relief to be granted.

Thank you, Mr. Chairman, for entering this testimony into the record.

EXHIBIT B

PROPOSED FORMULA

The following table can be used to calculate the proposed tax deduction for operating rights resulting from the Motor Carrier Act of 1980.

REVENUE $ (MILLIONS)	%
0 - 25	10
25 - 50	8
50 - 75	6
75 - 100	4
100 +	2

The proposed tax deduction would be obtained by multiplying the average revenue for 1977, 1978 and 1979 times the appropriate percentage.

STATEMENT OF THE BUSINESS ROUNDTABLE
With Respect To
THE TAXATION OF U.S. CITIZENS WORKING ABROAD
Submitted To the
FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
May 8, 1981

The current provisions in the Internal Revenue Code for taxation of U.S. citizens working abroad impose a competitive disadvantage on U.S. corporations in the international marketplace. Legislation is needed which would exclude from tax all of the foreign earnings of most of these citizens.

Background

The United States is the only major industrial nation which taxes foreign source income on a citizenship basis. It taxes not only base salaries but also foreign allowances to the extent these amounts are not offset by deductions or exclusions provided under the Code.

Since the late 1920s, Congress has recognized the need to provide tax relief to Americans working abroad in order to promote foreign trade. Initially the relief was provided in the form of an unlimited exclusion for those who met certain foreign residency tests. This relief was later extended to those who were not foreign residents but who were physically present abroad for 510 full days during any consecutive 18 month period.

In 1953, a limitation on the exclusion for the latter group was imposed primarily to halt what was widely perceived as abuses by highly paid movie stars. The limitation, which was later extended to foreign residents, was deliberately set high enough so as not to affect most Americans working overseas. However, it was not adjusted to keep up with inflation. By the mid-1970s sharply rising overseas living costs as well as rising salary and benefit levels had overtaken the amounts that could be excluded from foreign earned income.

Congress addressed this problem by passing the Foreign Earned Income Act of 1978 which generally replaced the existing exclusion with a series of deductions for extraordinary overseas living expenses. An alternative limited exclusion was made available for overseas Americans living in qualified camps in remote hardship areas.

Unfortunately, the new deductions have not proved sufficient to offset the added expenses incurred in working abroad, and neither the exclusion for those living in camps nor the deductions have provided the tax relief required to put overseas Americans on an equal footing with citizens of competing foreign nations. Moreover, tax returns are more difficult and expensive to prepare under the 1978 Act complex rules.

82-820 O—81——11

Scope of the problem

Americans who work in countries with high tax rates and pay foreign taxes equal to or higher than the U.S. taxes imposed on their foreign earnings, generally have no net U.S. tax liability after application of foreign tax credits. These Americans are not disadvantaged from the point of view of taxes when compared to citizens of competing nations who work in the same countries. Americans working in countries which impose low taxes or no taxes, however, may incur significant U.S. tax liability on their foreign earnings whereas their counterparts from competing nations generally incur no home country tax liability on their foreign earnings. Thus, the problem of U.S. taxation of expatriates is largely a problem in low tax countries. This is significant witn low tax countries such as most Middle East countries which accounts for a large portion of today's major foreign trade opportunities.

Effect on U.S. exports

Because corporations that send employees overseas generally find it necessary to pay tax allowances when employees incur excess taxes, U.S. corporations with Americans stationed abroad in low tax countries have an element of cost not shared by competing corporations whose overseas employees are not U.S. citizens. Where cost is an important factor, this can result in a loss of business to foreign competitors and acts as a disincentive to American corporations to compete abroad.

Moreover, in large part because of the cost of tax allowances, American corporations which continue to operate abroad are turning increasingly to foreign nationals or citizens of third countries to staff overseas positions. This results in reduced U.S. presence abroad with its serious consequences for U.S. exports. American employees responsible for purchasing goods and services are more likely to order from American firms or to specify American products than are employees who come from other countries. Also, Americans living abroad tend to bring their U.S. lifestyle with them, thereby exposing U.S. products to the local population and creating a local demand.

General Accounting Office study published on February 27, 1981

GAO completed an in-depth study of the impact of the Foreign Earned Income Act of 1978 and its effect on employment of U.S. citizens abroad. The study confirms that the Act does not fully meet its goal of relieving taxes on income reflecting excessive costs of living abroad. It notes that U.S. firms surveyed in the study have reported decreases in employment of Americans overseas both in absolute numbers and relative to employment of third country nationals.

The study urges Congress to consider placing Americans working abroad on an income tax basis comparable to that of citizens of competing countries. It concludes that this could be accomplished by a "complete exclusion or a limited but generous exclusion of foreign earned income for qualifying taxpayers".

Proposed legislation to solve the problem

During the past two years a number of bills have been considered by both houses of Congress. In the debate that followed, both Congress and industry have had the opportunity to study the various approaches carefully. Attachment A summarizes four bills which are currently under consideration by the Senate. These bills reflect an increased understanding of the problem and are superior to some which were considered earlier. They would provide relief ranging from total exclusion of foreign earned income (Jepsen bill); a $75,000 exclusion (rising to $95,000 in 1985) plus a deduction for excess housing costs (Bentsen bill); an exclusion of the first $50,000 plus half of the next $50,000 along with an exclusion for excess housing costs (Chafee bill); and a flat 80% exclusion (Moynihan bill).

Recommendations

Legislation should be adopted to exclude from tax all of the foreign earnings of most Americans working abroad. If there is a limit on the exclusion, a periodic review of the limit should be mandated and a separate deduction or exclusion for excess housing expenses should be provided. To insure equity and simplicity, the exclusion should not be limited to income earned in target countries or to individuals in targeted industries or occupations.

ATTACHMENT A

FOUR BILLS CURRENTLY UNDER CONSIDERATION BY U.S. SENATE

- S.598 - Introduced by Senator Jepsen.
  - Unlimited exclusion of foreign earned income.
  - Available for bona fide foreign residents and those physically present abroad for 510 full days during 18 consecutive months.
  - Foreign taxes on excluded income not creditable.
  - Effective for years beginning after December 31, 1981.
- S.436 - Introduced by Senator Bentsen.
  - Elective exclusion of $75,000 of foreign earned income for 1981 (would increase $5,000 per year to $95,000 for 1985 and later years).
  - Deduction for reasonable housing expenses incurred in excess of $5,500.
  - Available for bona fide foreign residents and those physically present abroad for 330 full days during 12 consecutive months.
  - Lodging furnished in camps would be excluded under Section 119.
  - Foreign taxes on excluded income not creditable.
  - Effective for years beginning after December 31, 1981.
- S.408 - Introduced by Senator Chafee.
  - Elective exclusion of first $50,000 plus half of next $50,000 of foreign earned income.
  - Elective exclusion of reasonable housing expenses in excess of 16% of salary rate for step 1, grade GS-14 Government employee.
  - Available for bona fide foreign residents and those physically present abroad during 330 full days during 12 consecutive months.
  - Lodging furnished in camps would be excluded under Section 119.
  - Foreign taxes on excluded income not creditable.
  - Effective for years beginning after December 31, 1980.
- S.867 - Introduced by Senator Moynihan.
  - Elective exclusion of 80% of foreign income.
  - Available for bona fide foreign residents and those physically present abroad for 330 days during 12 consecutive months.
  - Foreign taxes on excluded income not creditable.
  - Effective for years beginning after December 31, 1980.

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May 22, 1981

Honorable Bob Packwood
Chairman, Subcommittee on Taxation &
Debt Management
Senate Committee on Finance
United States Senate
Washington, D. C. 20510

Attention: Robert E. Lighthizer, Chief Counsel

Re: May 8, 1981 Hearings on S. 639

Dear Mr. Chairman:

This statement is submitted in support of S. 639, relating to incentive stock options, and to bring to your attention several technical problems, which, if corrected, will make the bill more effective to accomplish its intended purpose.

S. 639 would create a new category of stock options, termed incentive stock options. Such options would combine features of pre-1969 law applicable to restricted stock options and qualified stock options, but would not be defined in precisely the same terms as either of those other types of option. Under S. 639, tax rules similar to those in prior law for restricted and qualified stock options would apply to incentive stock options. The employee would not recognize income on receipt or exercise of the option, but would be taxed at capital gains rates on any gain at the time of sale of the stock, and the employer would not receive a deduction with respect to the optioned stock.

A principal purpose of the bill is to promote productivity by making it more attractive for employees to obtain an ownership interest in the corporation for which they work, a significant factor in motivating superior employee performance. As a result of changes in the tax rates previously made (for example, the maximum tax rate on personal service income), the incentive effect of the bill can be accomplished with negligible impact on current revenues and, as the Staff of the Joint Committee on Taxation has stated, enactment of the bill is estimated to increase budget receipts in future years.

This firm represents a number of corporations that presently maintain stock option programs for their employees, and can affirm the importance attached by them, in developing incentives for attracting and motivating employees, to stock option programs of the type envisioned by S. 639. However, we believe that there are several respects in which the bill could be further improved to accomplish its intended purpose.

First, as presently written, the favorable treatment afforded under the bill would apply, at the election of the corporation, to outstanding non-qualified options issued on or before December 31, 1980, that otherwise meet the requirements set forth in the bill. However, many outstanding options may have been modified, for one reason or another, prior to enactment of the bill. Moreover, a number of existing non-qualified stock option programs may presently contain technical deficiencies that would prevent their qualification as incentive stock options under the bill. In each case, the existing section 425(h)(1) of the Internal Revenue Code of 1954 could well preclude such plans and outstanding options thereunder from qualifying for the favorable treatment available under the new provisions.

Under section 425(h)(1), any modification of the terms of an existing option which gives the employee additional benefits is considered as the granting of a new option. To qualify as an incentive stock option under S. 639, an option cannot have an exercise price below the fair market value of the stock on the date the option is granted. Hence, if the value of the stock involved has increased since the option was first granted, a modification of an outstanding option, either prior to enactment of the bill for a reason unrelated to the bill's provisions, or subsequent to enactment of the bill to correct a technical deficiency in order to secure the benefit of the bill, could preclude the option from qualifying as an incentive option under the bill.

S. 639, as presently written, recognizes a similar problem in the case of outstanding options which have stock appreciation rights. Because the existence of stock appreciation rights might prevent treatment of such options as incentive stock options under the bill, Section 2(b) of S. 639 permits a corporation to modify or delete a stock appreciation right within six months after enactment of the bill without having the change treated as a "modification" for purposes of section 425(h)(1).

Options which, for one reason or another, were modified before the enactment of S. 639, should also not be precluded from qualifying as incentive stock options solely because of that modification. Nor should it matter that an option which was modified <u>before</u> enactment of the bill would not, as modified, meet the requirements for an incentive stock option. The technical deficiencies that would prevent qualification as an incentive stock option might still exist after such a modification. A previously modified option should be afforded the same opportunity subsequent to enactment of the bill to conform with the requirements of the bill as an option which was never modified.

The solution to these problems is to expand Section 2(b) of the bill to provide that section 425(h)(1) shall not apply to any changes (not just changes made for the purpose of modifying or deleting stock appreciation rights) to existing stock option plans and outstanding options made within a specified period after enactment of the bill to bring a plan and outstanding options thereunder within the scope of the bill's provisions, and to any modifications in the terms of an option or plan made before the date of enactment. Since some modifications may require shareholder approval, in order to avoid the costs of special shareholder solicitations and meetings, it should be provided either that such modifications may be made within a 12-month period after enactment of the bill; or, if a six-month modification period is used, it should be provided that the date of any modification subject to shareholder approval shall be determined as if such shareholder approval were not required. Cf. Section 425(i).

Such an amendment would be consistent with the past practice of Congress in this very context. In the

Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, Congress introduced special rules applicable to qualified stock options. The new qualified stock option provisions were applicable to taxable years ending after December 31, 1963, but section 221 (e)(3)(B) of the Revenue Act provided that section 425(h)(1) of the Internal Revenue Code would not apply to any changes made in the terms of an option made prior to January 1, 1965, to permit the option to qualify under paragraphs (3), (4), and (5) of section 422(b) of the Internal Revenue Code.

A second problem we wish to bring to the attention of the Subcommittee relates to the period for exercise of an incentive stock option in the case of the death of an employee-optionholder. Employee stock option plans commonly provide that in the case of death the option may be exercised by the person or persons to whom the employee's option rights pass by will or on intestacy. Moreover, because of the time needed to organize and administer a decedent's estate, such plans often provide that the option may be exercised within a period of up to one year after death. In the case of an non-qualified stock option plan, where there is presently no need to limit exercise of an option to a maximum ten year period, it is therefore possible that an employee stock option may be exercisable more than ten years after it was granted -- this would be the case if an employee were to die more than nine years after the date his option was granted. Permitting a longer exercise period in this limited situation, in recognition of the very real practical problems involved in organizing and administering a decedent employee's estate, does not in any way conflict with the objectives or purposes of S. 639, and it is therefore recommended that a limited exception to the maximum ten year option exercise period rule contained in Section 422A(b)(3) be made, to permit exercise by a decedent's representatives within a one year period following the decedent's death.

A final matter we wish to bring to your attention relates to the treatment of options that also embody stock appreciation rights. Stock appreciation rights may take many forms, but they generally involve a right on the part of an employee, upon surrender of all or a portion of an outstanding stock option, to receive, without payment to the corporation and in lieu of the stock otherwise available under the option surrendered, an amount (sometimes in cash, other times in stock, or a combination of cash and stock) equal to the excess of the market value of the shares covered by the option on the date of surrender over the exercise price under the option. A principal purpose of stock appreciation rights is to provide employees who are not in a position to make the financial outlay required to exercise a stock option the same performance incentives that are afforded to employees who have the cash with which to exercise a stock option, and to provide an alternative means to obtain an equity interest in the employer.

Although the matter is not entirely free from doubt, the position of the Internal Revenue Service would appear to be that the existence of stock appreciation rights or other alternative rights in tandem with a stock option would preclude a stock option from qualifying as an "incentive stock option" under S. 639. As noted previously, the sponsors of S. 639 recognized this prospect, and hence the bill permits the elimination of stock appreciation rights subsequent to enactment of the bill into law without affecting an option's qualification as an "incentive stock option."

We do not believe that there are any policy reasons requiring disqualification of an option from "incentive stock option" treatment merely because of the existence of stock appreciation rights. Therefore, we recommend that S. 639 be amended to provide expressly that the existence of stock appreciation rights or other alternative rights in tandem with a stock option shall not preclude the option from qualifying as an "incentive stock option." Of course, the favorable tax treatment available upon exercise of "incentive stock options" would not apply to the exercise of stock appreciation rights in lieu of such options. Instead, the amount received by an employee who exercises stock appreciation rights would be fully taxable as personal service income at the time the appreciation rights are exercised.

In our view, this provision would further the purposes of the bill significantly. All employees covered by such a stock option plan, not just those who anticipate being in a financial position to exercise the option, have an incentive to improve the productivity and hence the profitability of their employer, since they will benefit therefrom. An express provision permitting inclusion of stock appreciation rights without disqualifying the plan would make even more effective the "incentive stock options" contemplated under S. 639.

We have attached suggested amendments to S. 639 that would implement our recommendations.

Respectfully submitted,

Arnold C. Johnson

Arnold C. Johnson

Attachment

82-820 O—81——12

SUGGESTED AMENDMENTS

1. Revise paragraph (b) of "Section 2. Effective Dates and Transition Rules" of S. 639 to read as follows:

> "(b) For purposes of determining whether an option is an incentive stock option under section 422A, in the case of an option granted before January 1, 1982, paragraph (1) of section 425(h) of such Code shall not apply --
>
> (1) to any modification in the terms of such option made before the date of enactment of this Act; and
>
> (2) to any change in the terms of such option made within twelve months after the date of enactment of this Act to permit the option to qualify as an incentive stock option under section 422A of such Code."

2. Amend subsection (b) of Section 422A, as proposed to be added by S. 639, by adding at the end thereof the following new sentence:

> "An option otherwise meeting the requirements of paragraph (3) shall not be disqualified because it is exercisable at any time within the twelve-month period following the decedent's death by the person or persons to whom the optionee's rights pass by will or the laws of descent and distribution."

3. Amend subsection (c) of Section 422A, as proposed to be added by S. 639, by adding at the end thereof the following new subparagraph:

> "(6) An option which otherwise meets the requirements of subsection (b) may not be disqualified as an incentive stock option because the option is related to or associated with any alternative rights (such as stock appreciation rights) which may be exercised in lieu of the option."

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SENATOR BOB PACKWOOD, CHAIRMAN
COMMITTEE ON COMMERCE, SCIENCE & TRANSPORTATION
SENATE OFFICE BLDG.
WASHINGTON DC 20510

DEAR BOB,

THE MEMBERSHIP OF THE OREGON TRUCKING ASSOCIATIONS WOULD LIKE TO BE ON RECORD IN SUPPORT OF S.702 WHICH WOULD ALLOW DEPRECIATION OF MOTOR CARRIER OPERATING AUTHORITY.

IN DISCUSSING THE MAY 8 PUBLIC HEARING WITH YOUR STAFF, WE TENTATIVELY RESERVED TIME FOR A PERSONAL APPEARANCE, BUT IT NOW APPEARS THAT IT WILL BE IMPOSSIBLE TO COME TO WASHINGTON. FOR THIS REASON, WE WOULD APPRECIATE IT IF THE RECORD WOULD SHOW THAT THE OREGON TRUCKING ASSOCIATIONS FULLY SUBSCRIBES TO AND SUPPORTS THE POSITION OF THE AMERICAN TRUCKING ASSOC-ICATIONS.

BEST PERSONAL REGARDS,

ROBERT R. KNIPE, PRES,
OREGON TRUCKING ASSOC.

16:57 EST

MGMCOMP MGM

MAY 8, 1981

SUMMARY OF THE STATEMENT OF
PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION

1. The Problem. The technical leadership of the U. S. petroleum equipment services industry is being challenged by foreign competitors who are more price competitive in world markets because of the tax costs of maintaining American employees abroad.

2. Americans Losing Jobs Overseas. While there has been a tremendous explosion of oil and gas activity, the jobs which would have normally gone to U. S. citizens are going to foreign nationals. The increase in employment abroad of third country and local nationals by U. S. petroleum supply companies from 1975 through 1980 was more than twice the growth in Americans so employed. By training foreign personnel we are exporting our technology, thereby exacerbating the loss of technological superiority by U. S. manufacturing and service firms.

3. Exports are Vital to Our Industry. Exports support research and development. Worldwide operations provide a testing ground for new equipment.

4. The Need for American Technicians Abroad. Salesmen, servicemen and engineers must be available at or near a well site to sell and service U. S. equipment and supplies.

5. The High Cost of Maintaining Employees Abroad. Many costs have been cited. One should not overlook the cost of hiring expert tax assistance due to the complexity of the present act. One cannot overlook the colossal cost of housing in many areas abroad. One company recently entered into a five year lease of a three bedroom house in Lagos, Nigera for $51,400 per year--payable in advance--a total cost to move in of $257,000.

6. PESA Recommends. We strongly recommend passage of S.436. This bill has a reasonable income exclusion with a maximum limit to avoid abuse and it recognizes the housing problem resulting from rampant inflation in many countries.

STATEMENT OF
PETROLEUM EQUIPMENT SUPPLIERS ASSOCIATION
BEFORE THE
SENATE FINANCE COMMITTEE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
MAY 8, 1981

Petroleum Equipment Suppliers Association (PESA) represents approximately 225 companies with well over 200,000 employees. PESA members are the manufacturing and service companies which supply a substantial portion of the equipment and services used by the oil and gas producing industry in all parts of the world. In other words, PESA members furnish the hardware, the skilled services, and the supplies to the oil and gas industry in its search for and the production of oil and gas. PESA companies are small, medium and large, and sell to independents, major oil companies and government owned oil companies. Most PESA employees are United States citizens and a large percentage are stationed in various parts of the world. At these worldwide locations PESA members support the sale and service of products which are produced primarily in the United States and exported. It is because of our substantial stake in foreign markets that we are concerned about the legislation under consideration.

THE PROBLEM

In past years our industry's technological leadership and the reliability and superiority of United States products have made it possible for us to penetrate and maintain a dominant position in foreign markets. As a result our industry has historically generated substantial sales of United States manufactured equipment which has created jobs in the United States and aided in our nation's balance of payments position. Unfortunately, our status in the foreign marketplace has been seriously undermined by two developments:

(1) Technological advances by foreign competitors, and

(2) Changes in Section 911.

Our foreign competitors have made rapid technological advances both in the field of design and manufacturing capabilities. As a result we can no longer rely on our technical superiority to assure us of success in foreign markets. Competitive pricing is now becoming the factor which determines whether we will secure foreign sales. The change in the taxation of Americans working abroad has added tremendous amounts to our costs, making us less competitive in world markets. It is difficult for those in our industry to understand why our government would add this increased burden to our efforts to sell United States manufactured goods and services.

LOSS OF JOBS BY UNITED STATES CITIZENS

The chart on the cover of this statement highlights the result from an employment standpoint. The petroleum industry has experienced tremendous expansion in recent years due to the high prices of oil and the world need for a source of energy. Nevertheless, Americans have not realized their share of the employment increases in foreign locations. The graph covers the period 1975 through 1980 and reflects information accumulated by Price Waterhouse from a confidential survey of our members. The survey shows that third country nationals employed abroad by our companies increased 94%. The employment of local nationals increased 89%. Yet despite this obvious need for increased employees abroad in the petroleum services industry, the employment of United States citizens abroad increased only 37%. And why have Americans lost out abroad? Since 2 1/2 Englishmen can be hired for the cost of one American due to the American's tax treatment a United States company has no choice but to replace its United States employees working overseas with foreigners. Our experience is that American salesmen, servicemen and technicians are better trained, more dependable, more experienced, and more loyal to United States companies and United States products than foreign nationals. Nevertheless, faced with price competition our companies have had to look elsewhere for its employees.

One of our companies was forced to establish training facilities in Montrose, Scotland and Singapore to train Scotsmen, Britains, Frenchmen, Germans, Norwegians, Danes and other nationals to service and install its equipment. By training these foreign nationals, we are exporting our technical superiority and rapidly eliminating any United States technical advantage.

This is because there is no way to recover technology that has been implanted in the minds of foreign personnel. This training alone has gone a long way toward allowing foreign competitors to play catch-up with United States technology.

THE NEED FOR EXPORTS

The importance of exports to the economy of the United States is well known. Not so well known is the fact that exports are especially vital to our industry because:

(1) Exports support research and development, and

(2) Worldwide operations provide a testing ground for new equipment.

A large percentage of the equipment and services now offered in our industry was not available ten years ago. In an effort to stay ahead of foreign competition, PESA members spend an enormous amount on research and development each year. Without export sales to foreign markets, we would have to absorb the total burden of research and development. By increasing exports the cost of research and development can be spread over a larger volume of sales thus reducing costs for the production of oil and gas in the United States.

By providing equipment and services on a worldwide basis our member companies have access to a wide variety of operating problems and sub-surface conditions. New and improved technologies which were developed to meet the conditions existing in the North Sea, for example, have been of substantial benefit in the search for oil and gas offshore in the United States. Equipment required to resist the highly corrosive effects of the high sulphur content wells currently being drilled in the United States was developed, tested, and put into service in Canada and the Arabian Gulf. The testing and development of such equipment has been of enormous benefit in our search for domestic oil and gas.

THE NEED FOR TECHNICIANS ABROAD

In our industry experience has shown that the only way to make a substantial penetration in a foreign market is to have salesmen active in and servicemen available in the foreign areas involved. Down time in oil and gas drilling is expensive and we must maintain stocks of equipment and a staff of trained personnel, both of which are immediately available at or near the well site, to shorten the down time as much as possible. We must have people present to install, repair and maintain our products.

THE HIGH COST OF MAINTAINING EMPLOYEES ABROAD

It is axiomatic that oil and gas seems to be located in some of the most unattractive areas on the earth, such as offshore, in jungles, and in deserts. In the areas where we must send our employees it is usually very expensive to maintain a standard of living which is considered even adequate by United States standards. Rampant inflation in many countries continues to rapidly escalate the costs of maintaining United States citizens abroad. Many of the excess costs of living abroad have previously been cited. Two should be emphasized in particular. One is a result of the complexity of the present act, and the second is a cost which has reached outrageous proportions in some areas. Since all employers must have a program to reimburse employees for income tax on excess foreign costs, the computation of the employees' tax liability is important. Due to the enormous complexity of the current law, it is necessary to employ outside experts to make this calculation. The cost for this service is now running between $700 and $1,000 per employee per year.

The second expense to be highlighted is the cost of housing. This cost has continued its rapid escalation all over the world. A survey of some of our companies has revealed the following housing costs at the present time.

- One company has an employee in London in a 3 bedroom house renting for $36,000 a year.
- A Manager in London has been living in a house under a three-year lease, now expiring, at a rental of only $20,000 a year. In negotiations to extend the lease the landlord offered a 70-year lease for $500,000.
- An Engineer in Abu Dhabi is paying $50,000 a year for a 3 bedroom, two bath home.
- One of our companies recently rented a 3 bedroom home in Lagos, Nigeria for a Controller. The rental on this house was $51,400 a year and the landlord required 5 years payment in advance, a total of $257,000.

Bear in mind that these are not what we in the United States would characterize as luxury dwellings. Also remember, these prices do not include utilities or the high cost of security in some locations, nor do they include items we would expect in a leased home, such as built-in cabinets, light fixtures, carpets or drapes, all of which must be supplied in addition.

PESA RECOMMENDS

We have examined the bills pending before the Senate and strongly recommend to the Subcommittee S.436. This bill provides a reasonable exclusion with a maximum limit to avoid abuse. In addition, it recognizes the need for separate treatment of the cost of housing which, as previously shown, can be sufficiently large to completely offset an exclusion. The bill also recognizes that the present residency requirements are too long since the excess costs of living abroad begin as soon as an employee moves outside the United States.

We urge that you give rapid consideration to this problem as the taxation costs of having American employees abroad has reached crisis proportions and places United States' businesses at a distinct competitive disadvantage in the foreign marketplace.

Respectfully submitted,

Carswell H. Cobb
Chairman, Tax Committee
Petroleum Equipment
Suppliers Association

STATEMENT OF KEN KIVETT
CENTRAL TRANSPORT, INC.
TO COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

APRIL 7, 1981

My name is Ken Kivett. I am Comptroller of Central Transport, Inc. of High Point, North Carolina. My company transports commodities in bulk liquid and dry between all points in the United States. We have annual gross revenue of about $23 million.

I thank you, Mr. Chairman and members of the Committee, for the opportunity to share our thoughts concerning the tax aspects of President Regan's economic program, specifically concerning an aspect of great importance to the Motor Carrier Industry and Central Transport, Inc. The purpose of this testimony is to discuss the necessity of a proposed income tax deduction relating to the effect of the Motor Carrier Act of 1980 on carrier operating rights.

We agree that legislation is needed, but we disagree with the method presented in H. R. 1964. We think a formula should be used in allowing for tax relief that is fair and equitable to all motor carriers, not just the one's which have acquired operating rights in recent years. Example: two identical segments of operating authority between certain points had identical values on July 1, 1980 when the Motor Carrier Act of 1980 made these rights virtually worthless. The tax relief should be identical, fair and consistent for the owners of that identical authority. Simply because one company bought authority and another company applied for and acquired the authority through the Interstate Commerce Commission many years ago does not mean that the tax relief should be different. We want an equitable, consistent, fair formula, which will recognize the economic loss of both companies on a consistent basis. H. R. 1964 as now written is discriminatory and should be modified to eliminate this unfair feature.

Mr. Chairman, Central has been operating with the same owner over the last thirty years. The owners have not milked the company of its assets and have tried to build up the equity. Central is now being discriminated against in favor of the companies which have often purchased bankrupt companies' operating right. We strongly encourage that equity be considered in H. R. 1964 to eliminate the now existing discriminatory aspects of that bill.

Legislation is necessary to compensate carriers for the real loss in value sustained by the enactment of the Motor Carrier Act of 1980. During Committee consideration of the legislation, equitable legislation should be built into H. R. 1964 by using a fair, consistent method for determining the tax relief to be granted.

Thank you Mr. Chairman, for entering this testimony in the record.

TRW

EXECUTIVE OFFICES

May 18, 1981

The Honorable Robert Packwood
Chairman, Subcommittee on
Taxation and Debt Management
U. S. Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Attention: Mr. Robert Lighthizer

Dear Mr. Chairman:

I am writing on behalf of TRW Inc. to support S.639, a bill introduced by you to create employee incentive stock options. TRW is a diversified worldwide manufacturer of high technology products and services for car and truck, electronics and space, and industrial and energy markets. TRW employs 96,000 people worldwide and has gross sales of $4.98 billion.

Testimony provided to the Subcommittee on Taxation and Debt Management last year and again on May 8, 1981 has adequately indicated the need for increased stock incentives for employees and the desirability of restoring restricted stock options as a method of filling that need. Testimony before the Subcommittee has outlined four major points: (1) restricted stock options encourage productivity and capital formation; (2) they help growing and dynamic companies attract and retain employees even if high cash compensation is not feasible; (3) they eliminate the inequitable tax treatment that occurs under current law; and (4) they have positive economic recovery effects which increase federal revenues. This testimony will concentrate on the productivity and revenue aspects.

TRW INC. • 23555 EUCLID AVENUE • CLEVELAND, OHIO 44117

Statistics on American productivity are not very encouraging and have been the subject of numerous articles and recent congressional hearings. One generally accepted reason for lags in productivity growth is insufficient savings and investment. To remedy this, President Reagan has proposed an Economic Recovery Package which TRW fully supports. We are encouraged by the recognition of the problem by Congress and sincerely hope quick action will provide the necessary stimulus for recovery. We suggest, however, that passage of S.639 in a second tax bill would complement such stimuli by encouraging savings and investment in one's own company. This would provide an infusion of capital for many companies and ensure that a higher proportion of individual savings from marginal rate reductions are invested in productive assets.

A second reason for slow productivity growth is lack of motivation by employees. The greatest benefit of employee incentive stock options can lie in this area since an employee can only profit from a stock option if the value of the company's stock increases. It is, therefore, an efficient way of giving an employee a direct stake in the company and the motivation to increase the value of that stake. The increase in motivation will be reflected not only in terms of output quantity, but also quality and innovation which is the key to overseas competition.

On May 1, 1981, Robert M. Lynas, Vice President and General Manager of Chassis Components Group, Automotive Worldwide, TRW Inc., testified before the Joint Economic Committee. The subject of this testimony was "The Effect of Business Management Practices on Productivity", and several points he made then are relevant to consideration of S.639.

As compared with labor in other countries, an American worker can be every bit as productive. To be so, however, he must be given the proper tools, trained and managed properly, and must be given some incentive to learn, produce and grow with the company. Employee incentive stock options can be one form of that incentive.

A second major area to be considered is the revenue impact. It has been estimated by the Joint Committee on Taxation that the revenue loss in three years would be less than $2.5 million. From that point on there would be net gains of up to $30 million per year, six years after enactment. In a year when Congress is attempting to reduce taxes and reduce the deficit, and simultaneously trying to stimulate the economy, the employee incentive stock option is unique in working toward all three goals.

An additional positive feature of this bill is that it would allow favorable incentive treatment not only on options granted in the future, but also currently held, unexercised options. This avoids complexity and inequitable treatment of presently held options. Also, the positive revenue impact will be felt sooner because of this feature. Allowing the employee to exercise this already granted option under the new rules and not allowing a deduction to be taken by the corporation minimizes the initial impact of federal revenues and starts the motivation process immediately.

In conclusion, Mr. Chairman, I would like to reemphasize that the bill before the Subcommittee, S.639, presents an opportunity to enhance productivity. Employee incentive stock options assist small business as well as large, and will be particularly helpful to growing, dynamic firms, precisely the kind that are the most productive and most competitive with businesses abroad.

We appreciate the prompt hearings on this subject and hope the Subcommittee will take positive action on this needed legislation.

Sincerely,

Howard V. Knicely
Vice President
Human Relations

HVK/ai

GULF RESOURCES & CHEMICAL CORPORATION
47th Floor ○ 1100 Milam Building ○ Houston, Texas 77002 ○ (713) 658-0471

May 8, 1981

Senator Bob Packwood
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Donald P. deBrier
Vice President and General Counsel

S. 639--Incentive Stock Options

Dear Mr. Chairman:

These comments are submitted in support of the enactment of S. 639, relating to incentive stock options. We support this legislation because we believe that it represents the best way to deal with stock options granted to employees. We also believe that S. 639 should be strengthened by allowing stock appreciation rights to be utilized in conjunction with incentive stock options.

As a general rule, when an employer transfers property to an employee, the fair market value of that property is taxed to the employee at the time of transfer at ordinary income rates, and is deductible by the employer at the time of such transfer. This general rule does not apply to an option granted to an employee unless the option has a readily ascertainable fair market value when granted. Under the Treasury regulations, the typical employee stock option is not considered to have a readily ascertainable fair market value when granted, despite a 1976 directive from the Congress that standards for valuing options should be developed and that an employee should be allowed to elect to be taxed on the value of the option. As a result, when the typical stock option is exercised, the difference between the fair market value of the stock at that time and the amount paid by the employee is taxed to the employee as ordinary income and is deductible by the employer.

This tax treatment produces anamolous and unfair results. For example, assume that a corporation grants a ten-year option to buy one share of its stock for $10 (the current value of the stock) to each of three employees, A, B and C. A exercises his option in 1983 when the stock is worth $12 per share; B exercises his option in 1986 when the stock is worth $16 per share, and C exercises his option in 1991 when the stock is worth $14 per share. Under the tax treatment described above, A will have $2 of compensation for income tax purposes, B will have $6 of compensation, and C will have $4 of compensation. This disparity is difficult to rationalize in view of the fact that all three employees started out with the same option, paid the same amount to their employer and were left with the same asset (one share of stock). The only variation in these scenarios is the value of the stock on the dates of exercise. Nevertheless, the tax treatment varies widely. From the standpoint of the employer, the tax effect is equally unequal and unjustifiable.

Under S. 639, this disparity would be eliminated since no compensation would be deemed to be realized by the employee, or deemed to be paid by the employer, upon the exercise of an option meeting the statutory requirements. This proposed new legislation provides that an employee, who meets the various requirements of the bill, such as those relating to the length of time the stock must be held, will be taxed at capital gains rates when the stock is ultimately sold. Of course, the employer receives no deduction for the value of the stock at any time.

We also support the provision in S. 639 that would apply its substantive provisions to presently outstanding options. It is relevant in this regard also to note that the 1976 Congressional directive to the Treasury to develop standards for valuing stock options was never followed. We believe that this directive is an integral part of the 1976 legislation terminating the qualified stock option provisions and is clear evidence of Congressional intent to replace those provisions with provisions under which compensation would be realized but in a manner that results in uniform treatment and avoids the anomalies alluded to above. We believe that it is entirely appropriate for new legislation to apply to presently outstanding options so that the holders of such options are not subject to these anomalous tax consequences.

We further believe that S. 639 would be immeasurably strengthened if it were amended to permit so-called stock appreciation rights to be utilized in connection with incentive stock options. As you know, a stock appreciation right ("SAR") allows an employee to surrender a stock option for stock or cash (or a combination thereof) equal to the difference between the value of the stock at that time and the option price. For example, assume that an employee has an option to buy 100 shares of stock at $20 per share and that the value of the stock is now $50. If he exercises the option, he will receive $5,000 worth of stock after paying his employer $2,000, resulting in a net benefit of $3,000. If he exercises the SAR, he will receive $30 per share (i.e., $50 (current value) - $20 (exercise price)) or a total of $3,000 in stock, cash or a combination thereof. The economic benefit is the same in either case, but exercising the SAR permits many employees to avoid borrowing at today's astronomical interest rates. If the employee does exercise his stock appreciation rights, he will give up the right to receive $2,000 of stock and, more importantly, the ability to gain from the subsequent appreciation of the stock.

Therefore, we respectfully suggest that S. 639 be amended so that any stock received upon the exercise of a stock appreciation right be treated as stock qualifying under the proposed legislation. Upon receipt of such stock the employee would not be taxed (nor would the corporation receive a deduction), but upon ultimate sale of the stock the employee will be taxed at capital gains rates on the entire sales price of the stock since he will have a zero basis in the stock. Thus, the tax consequences upon the exercise of the SAR will be exactly the same as they would have been if the employee had exercised the option rather than utilized his SAR--, he will not receive any compensation in either event and no tax will be due until the ultimate disposition of the stock. Of course, in those situations involving stock appreciation rights where cash also is received, the employee would be subject to immediate taxation at ordinary income rates in the year of receipt with a concomitant deduction for the employer.

Sincerely yours,

Donald P. de Brier

Donald P. deBrier

Statement of Nicholas B. Romito
Assistant Treasurer, U.S. Truck Lines, Inc. of Delaware
In Support Of S. 702
Senate Finance Committee
May 26, 1981

U.S. Truck Lines, Inc. of Delaware is a motor transportation and management company. Our operating subsidiaries, Be-Mac Transport Company, Brown Express, Inc., Central Truck Lines, Inc., The Cleveland, Columbus & Cincinnati Highway, Inc., Motor Express, Inc. of Indiana and Mercury Freight Lines, Inc. are interstate motor common carriers. Each of these subsidiaries operates under certificates issued by the Interstate Commerce Commission (hereafter "I.C.C."). Our subsidiaries actively serve the public by transporting general freight throughout a large portion of the eastern two-thirds of the United States.

We strive to improve our interstate service through a program of continuous replacement and growth of our over-the-road equipment, and local delivery trucks, through upgrading our existing freight terminals and opening new terminals. We have also improved our service through acquisition of interstate motor carriers whose route systems complement our own. For example, in 1979 our subsidiaries collectively invested $16,310,631 for tractors, trailers and delivery trucks, $3,297,931 for terminals in Chicago, Illinois and Cleveland, Ohio, $670,543 for shop equipment, office equipment and other miscellaneous equipment, and $2,250,000 for the purchase of a certificate authorizing one of our subsidiaries to transport interstate freight. In 1980 our subsidiaries collectively invested $12,386,618.

Over the years, our company and its subsidiaries have made substantial capital investments in operating rights which were necessary to do business and which were recorded as intangible assets on its balance sheet. As a result of the Motor Carrier Act of 1980, these intangible assets have become virtually worthless, since the I.C.C. now freely authorizes firms to compete with our subsidiaries without making comparable capital investments. This severe reduction in value of these intangible assets has decreased the finanical worth of our company, because we were required to write off, as of December 31, 1980, assets valued at $14,071,745. Because Federal legislation has destroyed the value of these investments, it now seems reasonable and equitable that the Federal government provide relief for the substantial decrease in the net worth that interstate motor carriers, including ourselves, have suffered.

S. 702, which is now under consideration, would provide such relief. Such relief is not in any way unprecedented; indeed, when Prohibition was enacted, taxpayers with substantial investments in liquor licenses were permitted to deduct the amounts of those investments under the provisions of the tax laws then in effect.*/ Arguably, similar deductions may be available to taxpayers in our situation now under ~~section~~ 165 of the Internal Revenue Code; but in the absence of S. 702 or some equally clear mandate, taxpayers who claim such deductions may face protracted and costly disputes with the Internal Revenue Service.

We therefore support S. 702, and as evidence of this support, we request that this statement be included in the record of these proceedings.

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*/ See for example, Elston Co. to use and benefit of United States Brewing Co. v. United States, 21 F. Supp. 267, 86 Ct. Cl. 136 (1937), and Zakon v. Commissioner, 7 B.T.A. 687 (1927).

**STATEMENT OF C. V. WOOD, JR.
CHAIRMAN OF
THE COMMITTEE OF PUBLICLY OWNED COMPANIES
SUBMITTED TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE**

June 15, 1981

SUBJECT: S. 639

Mr. Chairman and Members of the Subcommittee:

My name is C. V. Wood, Jr. I am chairman of The Committee of Publicly Owned Companies, a nationwide association of 700 chief executive officers, founded in 1973, to support measures to facilitate capital formation, trim overregulation, spur exports and otherwise revitalize our Nation's economy.

On behalf of The Committee of Publicly Owned Companies, I would like to take this opportunity to endorse S. 639 introduced by Subcommittee Chairman Bob Packwood and Senator Lloyd Bentsen, to amend the Internal Revenue Code of 1954 with respect to the income tax treatment of incentive stock options.

The Committee of Publicly Owned Companies is vitally interested in the enactment of legislation which will permit and encourage the use of stock options by our members and corporations similarly situated. We believe that S. 639 is a sound and constructive measure to accomplish goals that are of special importance to small- and medium-sized corporations, like our

700 members, which provide much of the dynamism and innovation in our economy and are principal sources of new employment.

A critical problem for smaller, growing companies is attracting and retaining talented individuals in managerial and technical positions. It is these persons who are primarily responsible for the technological, production and marketing innovations which are the key to the vigor and competitiveness of the American economy. Our Nation faces an acute shortage of skilled employees in the coming years. According to NYU's Center for Science and Technology Policy, there probably will be 80,000 openings for synfuel engineers alone in this decade. Noteworthy, 46% fewer Americans obtained master's degrees in physics in 1980 than in 1970; in mathematics, the drop was 40%.

Small- and midranged companies cannot compete for talent with established, giant enterprises in offering immediate, current compensation in the form of salaries and bonuses. They can offer to talented individuals only an opportunity to share in the future growth and prosperity of the enterprise. With the expiration on May 20, 1981, of the qualified stock option legislation, however, this possibility is foreclosed, as a practical matter. S. 639 would make this essential instrument again available, on an improved and carefully structured basis which, as you Mr. Chairman have pointed out, will not result in a loss of revenue, but in a revenue gain after possible negligible losses in the first three years of its operation.

I should like to emphasize an aspect of this bill which is of cardinal importance. The special contribution of smaller, innovative companies to the national welfare is dependent upon dedicated personnel who will stay with the enterprise through the lean years of its early development, inspired by the prospect of a share in its long-term success. Younger, growing companies cannot survive unless their key personnel have the incentive to take the long view. The only practical instrument to encourage them to do this is a constructive stock option program made feasible and attractive by special tax treatment. S. 639 will make such programs available with, I am confident, substantial benefits to the Nation in terms of productivity, technological innovation and our ability to compete overseas.

The Subcommittee should be applauded for considering this vital measure, and we strongly recommend that the Congress proceed with the utmost speed to enact S. 639.

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