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THE TECHNICAL CORRECTIONS ACT OF 1987

HEARING

BEFORE THE

SUBCOMMITTEE ON

TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

S. 1350

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THE TECHNICAL CORRECTIONS ACT OF 1987

WEDNESDAY, JULY 22, 1987

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

The hearing was convened, pursuant to notice, at 9:40 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the subcommittee) presiding.

Present: Senators Baucus, Bradley, Roth and Chafee.

[The press release announcing the hearing follows:]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT TO HOLD HEARING ON TECHNICAL CORRECTIONS BILL

Washington, DC.—Senator Max Baucus (D., Montana), Chairman of the Senate Finance Subcommittee on Taxation and Debt Management, announced today that the subcommittee will hold a hearing on S. 1350, the Technical Corrections Act of 1987.

Chairman Baucus stated that the hearing is to serve two purposes—to hear comments on items included in S. 1350 and to receive recommendations for additional items to be included in any technical corrections legislation. Baucus emphasized that all testimony should relate to technical changes in the Tax Reform Act of 1986 and other recently enacted tax legislation.

The hearing is scheduled for Wednesday, July 22, 1987 at 9:30 a.m. in room SD-215 of the Dirksen Senate Office Building..

Senator BAUCUS. The subcommittee will come to order. This is the hearing on technical corrections of the 1986 Tax Reform Act, the various provisions which probably should be changed because of oversights or because of technical errors. There are other provisions that various groups would like also changed in the tax bill which sometimes are not in fact technical corrections. And there is obviously the effort and attempt of this subcommittee to keep any changes to the bill truly technical in nature. We do not want to have any significant substantive changes in this bill.

Our first witness is the distinguished Senator from Idaho, Senator Symms. And, Senator Symms, we are delighted to have you here to be our lead off witness. Please proceed.

STATEMENT OF HON. STEVE SYMMS, A U.S. SENATOR FROM THE STATE OF IDAHO

Senator SYMMS. Thank you very much, Mr. Chairman. I appreciate the opportunity to speak before this subcommittee. And I must say, as a former member of this committee, it seems strange to be on this side of the table. And I am very aware of the heavy workload that you have, so I will be as pertinent and direct as I can.

I come before you today to present my bill, S. 1188, to allow the establishment of 401(k) plans for college football coaches. The plan is companion legislation to Representative Duncan's H.R. 1093.

As members of the subcommittee know, the 401(k) plan allows individuals to move from one organization to another without losing accrued retirement benefits. I realize my bill is not technical in nature, however, the legislation addresses an important issue that needs immediate consideration.

Labor mobility is a crucial component of an economically efficient society. To encourage mobility, workers need to be assured that they can transport their pension plans as they move from one job to the next. Many coaches have no choice where they work or when they will be forced to relocate. For example, when a head coach moves from one school to another, there will be between 10 and 16 assistant coaches under him with uncertain futures. This type of change occurs every two or three years in the coaching profession. You can see it is very difficult to become vested in one pension system.

The American Football Coaches Association represents 5,500 coaches from 4-year colleges. This is a tax exempt organization which is not a collective bargaining group. These college coaches seek the use of 401(k) plans because the average length of one coaching position is 2.8 years, and it takes up to five years to become vested under the new Tax Code.

In addition, State pension plans and the Teachers Insurance Annuity Association—College Retirement Equity Fund vary from State to State. As a result, coaches have a very difficult time building secure retirement funds.

Although many major college head coaches are usually financially secure, there are many small college head coaches and assistant coaches who need the security that the 401(k) would bring. In fact, this issue has been brought to my attention by the assistant coaches at the University of Idaho. The vast majority of American Football Coaches Association members are actually assistant coaches whose futures are not nearly as secure as those head coaches that are more popularly known by most of us who watch college football.

A perfect example of how difficult it is for coaches to secure retirement funds is the case of Paul E. Davis who spent 38 years as a college coach. After many years as an assistant coach at several institutions, Coach Davis landed the head coaching job at Mississippi State University where he was the coach of the year in 1963. Davis then moved to Auburn University where he was assistant head coach for 14 years. Paul "Bear" Bryant, who respected him as a rival, gave Coach Davis a position as the head recruiter when Auburn's head coach was fired. "Bear" Bryant's action enabled Coach Davis to get the full Alabama State pension, but many coaches are not so lucky.

The American Football Coaches Association is seeking the use of the 401(k) because other pension plans, such as the Multi-Employer Pension Program and 403(B) Tax-Sheltered Annuity Provisions, do not apply to its needs. The American Football Coaches Association is not a collective bargaining group and does not seek to become one. And although some coaches can take advantage of 403(B), many coaches belong to institutions which do not maintain such a program. What these coaches need is a portable, uniform pension plan as provided for by the 401(K).

Finally, I would like to address the issue of why we are singling out 4-year college football coaches. I introduced the bill as a compansion legislation to H.R. 1093. The two bills read verbatim, however, I would be more than willing to modify the legislation at some point in the legislative process to include other collegiate level coaches.

Mr. Chairman, I thank you very much for the opportunity to discuss that issue. I have two other issues I want to mention only for about 10 to 15 seconds each.

One issue that I would hope in your deliberations this year that we could take a careful look—and I would offer my abilities, whatever they might be, to work with you on this—at calendar yearend dates for businesses using fiscal year ending dates other than December 31. I think that was a mistake in the tax bill. I don't know whether it is to be considered technical in nature or not, but I believe that we are creating a ripple effect in our society by forcing all of the accounting procedures for all businesses to be done on the same date. We should allow a staggered yearend date for individuals and businesses. I hope that we could look at that one.

And the last thing I would just mention in your deliberations, I am leaving this committee to go upstairs to the Public Works Committee, which the distinguished Senator from Montana also works with me on, and Senator Moynihan is undertaking a large project of hearings on the infrastructure in this country. I think all of us that have worked on that committee are very keenly aware of the fact that we have many of the older cities in the country with water systems, sewer systems, roads, bridges, and so forth that are in dire need of rebuilding, replacement and reconstruction, and in some places, new construction.

I would hope that this committee in any technical correction act, that it at least make a statement that we would call a truce on any further taxation on municipal bonds and do nothing more than was done in the 1986 Tax Reform Act. In other words, make a statement to the effect that municipal bonds will be off limits to any new forms of revenue that might come about just to give stability to those communities who need to use municipal bonds to finance infrastructure projects that are badly needed for the public good of communities. I would be glad to do anything on that with the chairman, to just make a statement that there will be a truce. We will use the law we passed and not tamper in any way with municipal bond taxation as a method of raising any revenues in the future.

I thank you very much again for your patience and for the opportunity to be here this morning.

Senator BAUCUS. Thank you, Senator.

The accounting measure of which you spoke is a subject that will be addressed later this morning, in fact, as I have introduced a bill to help address the accounting change that you mentioned.

Senator SYMMS. I think I am a cosponsor of it. I hope so.

Senator BAUCUS. If you are not, I will be sure that you are.

Senator SYMMS. Good.

Senator BAUCUS. On the major matter of which you testified, I am wondering what your feelings would be of other faculty or even of other sports personnel, coaching personnel in other sports of Division 1 colleges——

Senator SYMMS. Well,——

Senator BAUCUS [continuing] If the bill that you are testifying on were to enact it?

Senator SYMMS. There are two reasons why it is just football coaches. The first one is that the Joint Tax Committee estimates that the cost of it the way the bill is written is less than $5 million. Football coaches are obviously affected by this. I do think that other coaches—baseball, track, basketball—also probably should be considered. But the first reason was cost; to not expand it too broadly or too widely.

The second reason is that we introduced this bill verbatim with H.R. 1093, and it could be expanded. The portable pension concept lends itself to all workers; however, coaches, and particularly football coaches, are unique in that their average job expectancy is about 2.8 years.

Now, the head coaches of major institutions have a much higher income and have much more financial security. I am not as concerned about their future as their assistants who have no choice. And I cite an example.

The former head coach of the University of Idaho left Idaho 2 years ago and went to the University of Wyoming, but his lifelong dream was to be the head football coach at Washington State University. The job opened up at Washington State University, and he had to make a career choice: Does he go with his lifelong dream and move back to the PAC-10 and Washington State University and give up the secure position he had at Wyoming? He made the decision to make the career change and was able to do this under the contract that he had at Wyoming.

The problem is that the assistants that were at Idaho, and then at Wyoming, and now at Pullman, Washington, all are in a much lower income category than the head coach, and have families, and great difficulties of assuring any security. They have made three moves, in three football seasons, to three institutions, in three States. I just believe that they should be afforded some kind of an opportunity to be putting away a little bit of money for future investment. And I don't believe that the cost to Treasury will be significant.

Now if we want to expand it to basketball and the other sports, I would have no objection. As far as the academic instructors go on college faculties, they are not bound with a head football coach's career. In other words, they do not have to hang their star on a head coach and go with that coach and that program. They can get in the English Department or in the History Department and pretty much stay in place if they are happy at that institution, so then they are able to qualify under the institutional pension programs.

Senator BAUCUS. Thank you very much, Senator.

Senator SYMMS. Thank you.

Senator BAUCUS. There are two other Senators who are scheduled to testify, Senator Dodd, who apparently is not here yet, and

Senator Murkowski, who I am told is on his way. While we are waiting for Senator Murkowski, let's go to the first non-Senatorial witness, Mr. Don Chapoton, Deputy Assistant Secretary of the Treasury. The committee welcomes you, Mr. Chapoton, in your new role of representing the Treasury. Your brother was here sitting where you are, yesterday, and yesterday was also Secretary Mentz's last day, the last time he was here to testify. This committee has been blessed with the appearance of very competent Assistant Secretaries, helping this committee, advising this committee on the Treasury's position in tax policy and the revenue effects and whatnot of various tax bills. We look forward to join in the same relationship with you. You have had a great group preceding you and I know you are going to be doing just as well and probably even better.

[The prepared written statement of Senator Symms follows:]

SATEMENT TO FINANCE COMMITTEE ON S. 1188

I WOULD LIKE TO THANK THE CHAIRMAN AND MEMBERS FOR ALLOWING ME TO SPEEK BEFORE THE COMMITTEE THIS MORNING. I AM AWARE OF YOUR HEAVY WORKLOAD, SO I WILL BE PERTINANT. I COME BEFORE YOU TODAY TO PRESENT MY BILL, S. 1188, TO ALLOW THE ESTABLISHMENT OF A 401(K) PLAN FOR COLLEGE FOOTBALL COACHES. THE BILL IS COMPANION LEGISLATION TO REPRESENTATIVE DUNCAN'S H.R. 1093. AS MEMBERS OF THE COMMITTEE KNOW, THE 401(K) PLAN ALLOWS INDIVIDUALS TO MOVE FROM ONE ORGANIZATION TO ANOTHER WITHOUT LOSING ACCRUED RETIREMENT BENEFITS. I REALIZE THAT MY BILL IS NOT TECHNICAL IN NATURE, HOWEVER, THE LEGISLATION ADRESSES AN IMPORTANT ISSUE THAT NEEDS IMMEDIATE CONSIDERATION.

LABOR MOBILITY IS A CRUCIAL COMPONENT OF AN ECONOMICALLY EFFICIENT SOCIETY. TO ENCOURAGE MOBILITY, WORKERS NEED TO BE ASSURED THAT THEY CAN TRANSPORT THEIR PENSION PLANS WHEN THEY MOVE FROM ONE JOB TO THE NEXT. MANY COACHES HAVE NO CHOICE WHERE THEY WORK OR WHEN THEY WILL BE FORCED TO RELOCATE. FOR EXAMPLE WHEN A HEAD COACH MOVES FROM ONE SCHOOL TO ANOTHER, THERE WILL BE BETWEEN 10 AND 16 ASSISTANT COACHES UNDER HIM WITH UNCERTAIN FUTURES. THIS TYPE OF CHANGE OCCURS EVERY TWO OR THREE

YEARS IN THE COACHING PROFESSION. YOU CAN SEE THAT IT IS VERY DIFFICULT TO BECOME VESTED IN ONE PENSION SYSTEM.

THE AMERICAN FOOTBALL COACHES ASSOCIATION REPRESENTS 5,500 COACHES FROM FOUR YEAR COLLEGES. THIS IS A TAX EXEMPT ORGANIZATION WHICH IS NOT A COLLECTIVE BARGAINING GROUP. THESE COLLEGE COACHES SEEK THE USE OF THE 401(K) PLAN BECAUSE THE AVERAGE LENGTH OF ONE COACHING POSITION IS 2.8 YEARS, AND IT TAKES 5 YEARS TO BECOME VESTED UNDER THE NEW TAX CODE. IN ADDITION, STATE PENSION PLANS, AND THE TEACHERS INSURANCE ANNUITY ASSOCIATION--COLLEGE RETIREMENT EQUITY FUND (TIAA-CREF) VARY FROM STATE TO STATE. AS A RESULT FOOTBALL COACHES HAVE A VERY DIFFICULT TIME BUILDING SECURE RETIREMENT FUNDS. ALTHOUGH MAJOR COLLEGE HEAD COACHES ARE USUALLY FINANCIALLY SECURE, THERE ARE MANY SMALL COLLEGE HEAD COACHES AND ASSISTANT COACHES WHO NEED THE SECURITY THAT THE 401(K) WOULD BRING. IN FACT, THIS ISSUE WAS BROUGHT TO MY ATTENTION BY THE ASSISTANT COACHES AT THE UNIVERSITY OF IDAHO. THE VAST MAJORITY OF AFCA'S MEMBERS ARE ASSISTANT COACHES.

A PERFECT EXAMPLE OF HOW DIFFICULT IT IS FOR COACHES TO SECURE RETIREMENT FUNDS IS THE CASE OF PAUL E. DAVIS WHO SPENT 38 YEARS AS COLLEGE COACH. AFTER MANY YEARS AS AN ASSISTANT COACH AT SEVERAL INSTITUTIONS, COACH DAVIS LANDED THE HEAD COACHING JOB AT MISSISSIPPI STATE UNIVERSITY WHERE HE WAS COACH OF THE YEAR IN 1963. DAVIS THEN MOVED TO AUBURN UNIVERSITY WHERE HE WAS ASSISTANT HEAD

COACH FOR 14 YEARS. PAUL "BEAR" BRYANT, WHO RESPECTED HIM AS A RIVAL, GAVE COACH DAVIS A POSITION AS HEAD RECRUITER WHEN AUBURN'S HEAD COACH WAS FIRED. "BEAR" BRYANT'S ACTION ENABLED COACH DAVIS TO GET A FULL ALABAMA STATE PENSION. NOT EVERY COACH IS SO LUCKY.

THE AFCA IS SEEKING THE USE OF THE 401(K) BECAUSE OTHER PENSION PLANS, SUCH AS THE MULTI-EMPLOYER PENSION PROGRAM AND 403(B) TAX-SHELTERED ANNUITY PROVISIONS, DO NOT APPLY TO ITS NEEDS. THE AFCA IS NOT A COLLECTIVE BARGAINING GROUP, AND DOES NOT SEEK TO BECOME ONE. AND ALTHOUGH SOME COACHES CAN TAKE ADVANTAGE OF THE 403(B) PLAN, MANY COACHES BELONG TO INSTITUTIONS WHICH DO NOT MAINTAIN SUCH A PROGRAM. WHAT THESE COACHES NEED IS A PORTABLE, UNIFORM PENSION PLAN AS PROVIDED FOR BY 401(K).

FINALLY, I WOULD LIKE TO ADDRESS THE ISSUE OF WHY WE ARE SINGLING OUT FOUR YEAR COLLEGE FOOTBALL COACHES. I INTRODUCED THE BILL AS COMPANION LEGISLATION TO H.R. 1093. THE TWO BILLS READ VERBATIM. HOWEVER, I WOULD BE MORE THAN WILLING TO MODIFY THE LEGISLATION AT SOME POINT IN THE LEGISLATIVE PROCESS TO INCLUDE OTHER COLLEGIATE LEVEL COACHES.

STATEMENT OF HON. O. DONALDSON CHAPOTON, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, U.S. TREASURY, WASHINGTON, DC

Mr. CHAPOTON. Well I have a long line of strong people to follow, but I will do my best. I thank you very much.

We are happy to be here this morning, Senator, to testify on the Technical Corrections Act of 1987, S. 1350. I have been asked to keep my remarks very short, so I will do so. We have a printed statement that we would like to enter into the record, which contains a more detailed analysis of the comments that we have on the Technical Corrections Bill.

Let me just say by way of background that every major tax legislation over the last 8 or 10 years has necessarily been followed within a year by a technical corrections bill. The 1986 Tax Reform Act is no exception. In fact, I think everyone is to be commended—the staff and the Congress—for the relatively low number of technical corrections which are required on this Act. The 1986 Tax Reform Act was a major piece of legislation that dramatically reformed the Tax Code. There are necessarily a number of provisions that require corrections, but we think that they are relatively small in number, given the magnitude of the original legislation.

The Treasury Department supports virtually all of the provisions in the Technical Corrections Bill. Our staffs have worked closely with the staffs of the Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation, and we are very pleased with the way the Technical Corrections Bill has been drafted and the form in which it now stands.

There are, however, several matters about which we have some concern, and those matters are covered fully in my written statement. Basically, just to summarize, my written statement covers only six different items that are in the Technical Corrections Bill. Three of them relate to foreign matters and three of them relate to domestic matters.

Let me first turn to the foreign matters because I think that the primary one involved there is the one that gives us the greatest concern. This is the provision in the Technical Corrections Bill dealing with treaty overrides, that is, with conflicts between our bilateral tax treaties with foreign countries and provisions of the 1986 Tax Reform Act.

The 1986 Tax Reform Act contained a number of provisions which raise the question of whether the Act or the treaties would control; in other words, whether the Act provisions overrode the treaty.

While we had grave concerns that some of those provisions did, in fact, cause treaty overrides and would cause the treaties to be no longer effective as to those provisions which it conflicted with, at least the Act was silent on just how that determination would be made. It was left up to the courts to determine whether the treaties would control or the Act would control or whether any conflicting provisions between the two could be reconciled.

Unfortunately, from our point of view, the Technical Corrections Bill does not leave that open to question. It contains specific provisions saying when the Act will control or when the treaties will control, and we think that is unfortunate.

There are two specific provisions in the bill that say in those specific cases of conflicts, the Act provisions will control, and the treaty is overridden.

Eight other specific provisions are listed, indicating that where there is a conflict in those cases, the treaty will control.

And, finally, there is a catchall provision that states that in the case of "Any other provision that is deemed to conflict"—any other provision in a bilateral treaty that we have with a foreign country that is deemed to conflict with a provision in the Tax Reform Act, the Tax Reform Act will control.

This is not an insignificant matter. It is something that worries our major trading partners considerably. We have 35 bilateral treaties and we are hearing from those countries. As they view it, we are casually overturning treaties that have been negotiated with and that have been honored by those countries. They think that this is a serious matter that we should consider, that Congress should seriously consider, before acting upon.

About two weeks ago, the Treasury Department sent a delegation to the Committee on Fiscal Affairs of the OECD, in Paris, to discuss international tax relations and, among other things, international tax treaties. I led that delegation, and I can tell you that there was grave concern expressed by our major trading partners with respect to these treaty overrides.

As a result of those discussions that went on in that committee—and, incidentally, there are 24 countries represented in OECD meetings—a summary was made of the feelings of that committee on the treaty override provisions. While I, as a representative of the United States, had to withdraw and not participate in those discussions, I was requested by the OECD to bring that summary and their conclusions back to the Congress. It is contained verbatim in my written statement. It is one paragraph that appears on page 5. I would just like to read a couple of sentences from it.

"The Committee on Fiscal Affairs of the OECD was concerned about the increasing frequency with which in recent years, and particularly during the recent process of tax reform, the United States had sought unilaterally to override its own international agreements. This could only call into doubt the intentions of the United States when negotiating agreements and undermine the stated policy of the OECD."

My written statement contains in greater detail the reasons why this is of great concern, and I would hope that the committee would consider it. It is something I can assure you that is greeted with alarm by our trading partners. I think we should address and try to be reasonable in our response to their concerns.

My written statement contains two other foreign provisions that we have some concern about and that we think need some attention, but I think that is pretty well spelled out in my written statement so I won't dwell on those.

The written statement also addresses three technical corrections dealing with domestic tax matters which we would like to see changed from the way they now appear in the Technical Corrections Bill.

The first one has to do with the low income housing tax credit. I won't go into any detail except to say that the bill purports to change a provision in the low income housing credit provision that allows the Treasury Department to authorize a waiver of a 10-year holding period requirement for the purchase of housing for low income purposes. The bill would deny the Treasury under certain circumstances the ability to grant that waiver. We think that the waiver is quite important, and we would support at least revising it somewhat in the Technical Corrections Bill so that the Treasury does have some authority to grant that waiver in circumstances where it is needed, and particularly in light of the dire need for additional low income housing in this country.

Second, the written statement touches on a provision dealing with the treatment of foreign currency gains and losses for purposes of certain rules that apply to regulated investment companies. This is a very complex subject dealing with whether foreign currency gains should be subject to the so-called short-short rule which restricts regulated investment companies to realizing no more than 30 percent of their income from the sale of stock or securities held for less than 3 months. We think that there is no reason why foreign currency gains should be subject to the short-short rule, and without elaborating on that, my testimony touches on that.

The final point I would like to mention relates to the installments sales rule as it applies to passive losses. Senator Symms touched on this a moment ago. This is a provision which relates to a Treasury announcement about its proposed regulations under Section 469 implementing the Passive Loss Rules.

The Passive Loss Rules are very complex provisons in the Tax Reform Act, and we are working on regulations to deal with the complexities of those provisions. But in areas where we knew taxpayers needed some guidance, we sought to give that guidance early in the form of administrative announcements. This installment sale rule was one of those administrative announcements.

We announced that installment sales made before 1987 of rental property or other activities which, under the bill, when it came into effect in 1987, would have been considered passive activities would not constitute sales of passive activity investments and, therefore, would not be eligible for passive income treatment when the installment income was collected in 1987 and later years.

I think there has been some reaction to that announcement. The thinking is that it is unfair; that the concept that the defintional provision was not in effect in 1986 and, therefore, a sale cannot constitute a passive activity struck some individuals as unfair and as a too strict interpretation of the Act.

Our written statement goes into great detail as to why we do not think that is true, but let me just summarize it simply by saying that there is no indication in the Act anywhere that pre-1987 activities should be considered passive or active. Just the contrary. There is no notion of the "passive" characterization of the pre-1987. In the net operating loss area, if losses are realized pre-1987, they are going to be considered active losses whether they arose from a passive activity or an active activity. That is provided in the statute.

Second, any rule different from the one we provided, such as is provided in the Technical Corrections Bill, would have the impact of allowing taxpayers that sold pre-1987 activities which had been tax-sheltered (which, in many cases, were "burned out" tax shelters, where the losses had already been realized so that the sale of the activity would result in significant gains because of the reduction in basis through the write-offs of the losses) to continue to shelter that income a second time. Now that is a very broad brush analysis of that. I would be happy to answer any questions on it, but it is a matter of concern to us. It is something we studied at length and we think that an in-depth analysis does not indicate that it is unfair, but that, frankly, it is the most logical way to go to consistently apply the passive loss rules.

Mr. Chairman, that concludes my remarks. I would be happy to answer any questions about the details of the testimony or any other matters which you might have any questions about.

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

You raised a very interesting point in the concern that other countries raised that we tend to abrogate unilaterally our tax treaties and I share with you that concern. And I am wondering if we could explore that a little bit further.

I like your reactions to whether it makes some sense for this country to try to utilize a tool of tax treaties to gain more uniformity in tax accounting among various countries, a tax treatment of certain exchanges or business activities so that it would be better ways to get better ideas as to the degree to which one country is growing, developing versus another country. What I am trying to get at is I think a lot of different countries that tax individuals and tax business organizations differently, and it makes it difficult for an individual to operate because of different ways that they are taxed, and, second, it makes it difficult to compare our performance versus another country's performance, or even difficult to understand the degree to which a tax matter in one country truly affects that interprise, vis-a-vis the United States, because of all the changes.

I am wondering if it makes some sense in order to further your effort to encourage more conformance with tax treaties for this country to explore utilizing tax treaties as another way to help encourage international trade by eliminating some of these barriers that I mentioned.

Mr. CHAPOTON. You are quite right, Mr. Chairman. That is a very complex area. I think that is one of the very strong points that treaties bring to the overall impact on international trade. It is not an easy subject. It is a very difficult subject on how in any given country we can mesh our tax system with their tax system so that the multinational concerns can deal with their tax system, and learn how to pay it and get credit for it so that there is not a double tax. That, incidentally, is I think the greatest concern. For example, assume that you do business in Germany, and you pay tax on your German profits, then you re-patriate those profits to the United States. Do you pay tax again in the United States when you re-patriate those profits even though they have already been taxed once?

Treaties, by and large, aim at eliminating that double tax, and they attempt to work out and to put on a similar basis the different tax regimes in the different countries.

Germany, for example, just to cite one, has an imputation system so that shareholders there do not pay any further tax on their dividends. It is an integration system of the sort we have talked about here, an integrated tax system where all the tax is borne at the corporate level.

So the result is that most of the corporate profits are taxed at the corporate level and German shareholders will pay no further tax. But when those profits are earned by United States companies and repatriated to the United States, we, of course, impose another tax on the U.S. shareholders. Even though there is some credit available, it results in double taxes.

Senator BAUCUS. Is the Administration making a serious effort to try to address that problem?

Mr. CHAPOTON. Oh, absolutely. That one in particular.

Senator BAUCUS. Are you coming up to Congress sometime with a major bill or a major series of treaties, proposed treaties?

Mr. CHAPOTON. We are having to review all of our treaties in light of the Tax Reform Act. There are a number of treaties on the table and in various stages of negotiation right now. The difficulty is that dealing with every country is different, so that it is not possible to come up with one solution to all of the problems. So, we are dealing with them one at a time, separately, but with a number of negotiations going on at the same time. And we do have some treaties that are up here for consideration by the full committee and some more that are on their way very shortly.

Senator BAUCUS. To what degree should any of this be coordinated with the new GATT Round?

Mr. CHAPOTON. With the new GATT? Well, we keep an eye on that. We try very much not to run afoul of any of the GATT provisions in the treaty provisions. There is a uniform treaty that has been developed by the Treasury Department with the aid of the OECD and other treaty partners that is our starting point for new treaty negotiations. And we do meet with them regularly, so it is very much a cooperative effort. And I think it has been very productive and it is getting better.

Senator BAUCUS. One final question. You have seen the witness list that is before us this morning. Do you want to comment on any particular matter that you will hear about later?

Mr. CHAPOTON. Could I look at then back here? [Laughter]

Senator BAUCUS. You get the first shot.

Mr. CHAPOTON. There is one matter that is of some concern to us and that is the AICPA proposal on the fiscal year matter that Senator Symms referred to. We applaud the AICPA's efforts in trying to solve the problems created by the provision in the Tax Reform Act that requires all partnerships and sub S corporations to go on a calendar year and not fiscal year. We know that the provision is imposing a real burden, a real hardship on the accounting profession and we wish there were an easy solution to that. Unfortunately, there is a lot of revenue in the provision as written in the Tax Reform Act.

The AICPA proposal would save most of that revenue, but it is very complex. The Internal Revenue Service tells us they would have a great deal of trouble enforcing it the way it is written without increasing the staff; that it would be a difficult matter for them to handle. The proposal, as I understand it, would permit partnerships and sub S corporations to stay on fiscal years but would require them to make estimated tax payments or have their shareholders make estimated tax payments early on so that the revenues were not lost.

While that would protect most of the revenues, it would create the complexity I referred to, and for that reason, we have grave concern about it.

If something needs to be done in that regard it would appear to us that a more simplified approach is called for. We would like to work further with the AICPA and this committee in trying to solve the problem without losing the significant revenue involved.

One idea that has occurred to us that is not revenue neutral but might have some appeal is to have exceptions for small partnerships and sub S corporations, such as every partnership making less than $1 million would not be subject to the fiscal year rule. That loses money but it would also eliminate a large majority of the partnerships and sub S corporations from the rule.

So I guess, in summary, while we are very concerned about the provision—we understand the concerns that have been expressed—we are not happy with the proposed solution.

Senator BAUCUS. Mr. Chapoton, I hope we can work something out in that area because, based upon my personal experience, and the number of calls I have received and letters I have received, it is a significant problem that partnerships and subs corporations face. And it just seems to me that in order to serve our constituents, not lose revenue, not cause them undue complexity enforcement problems, we should try to find a way to merge the personal with the business accounting period and basically a calendar year. And I hope that we can find that solution.

Mr. CHAPOTON. Thank you, Mr. Chairman. We have been working on it and we will continue to do so.

Senator BAUCUS. Thank you very much, Mr. Secretary. We very much appreciate your testimony.

The next witness will be Senator Murkowski. Senator, we are very happy to have you here.

[The prepared written statement of Mr. Chapoton follows:]

For Release Upon Delivery
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STATEMENT OF
O. DONALDSON CHAPOTON
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department on S. 1350, the Technical Corrections Act of 1987. Every significant revision of the Internal Revenue Code in recent years has required subsequent legislation to correct technical errors and omissions in the original legislation and to permit the proper interpretation and administration of the law. It is therefore not surprising that numerous provisions of the Tax Reform Act of 1986 (P.L. 99-514) (the "Tax Reform Act" or the "Act") are in need of technical correction. What is surprising is the relatively low number of technical corrections, given the breadth of the changes made by the Tax Reform Act. Members of Congress and their staffs are to be commended for the care and skill with which they have drafted these changes.

The Tax Reform Act accomplished the most fundamental reform of the federal income tax system since its inception. By dramatically lowering income tax rates, broadening the tax base, and eliminating certain distortions created by former law, the Act significantly improved the fairness, simplicity, and efficiency of the tax system. The provisions of the Tax Reform Act affect nearly every aspect of the federal income taxation of individuals and businesses. The scope and significance of the Tax Reform Act make it essential that the necessary corrections and clarifications to the Act be considered carefully and enacted in a timely manner.

The Technical Corrections Act of 1987 (the "bill") includes amendments designed to cure oversights and clerical errors and to clarify or conform various provisions of the Tax Reform Act. The bill also includes technical corrections to the Omnibus Budget

Reconciliation Act of 1986 (P.L. 99-509), the Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), and the Superfund Amendments and Reauthorization Act of 1986 (P.L. 99-499). The proposed amendments are generally effective as if included in the original legislation.

The Treasury Department supports virtually all of the proposed amendments included in the bill. Many of the proposed amendments are vital for the proper interpretation and administration of the provisions they affect, and are therefore as important to tax reform as the original legislation. Since it would not be practical to describe or discuss each of the bill's many provisions, my testimony addresses only certain provisions that the Treasury Department opposes or believes require modification. I emphasize that my views represent only the views of the Treasury Department. Time has not permitted a complete review of the testimony within the Administration.

Because of the significance of the bill's provisions relating to treaties between the United States and foreign countries, I will begin my testimony with a discussion of these provisions, as well as the other foreign related provisions of the bill. I will then discuss the other provisions in the order in which they appear in the bill.

Coordination of the Tax Reform Act with Existing Treaties

Section 112(y) of the bill attempts to provide definitive rules for the coordination of the Tax Reform Act's provisions and pre-existing treaties. The approach taken is to identify provisions of the Act that are thought to conflict with one or more income tax treaties and to specify those provisions that would not apply to the extent inconsistent with pre-existing treaties and those that would override U.S. treaty obligations. In addition to treaty overrides already discussed in the Act, the bill enumerates two provisions of the Act that are intended to override treaty obligations and eight that would not apply to the extent contrary to a treaty obligation. Finally, section 112(y)(2)(C) provides that, in any other cases of conflict between the Act and treaties, the Act's provisions are to apply notwithstanding any treaty obligation of the United States.

The description of the bill prepared by the staff of the Joint Committee on Taxation (the "Staff Description") states that, "Except for cases that have been identified in the [bill] or the Act, no cases are known where a harmonious reading of the Act and U.S. treaties is not possible." The Staff Description analyzes a number of potential conflicts and concludes in each case that the Act provision is not in conflict with relevant treaty provisions. The residual treaty override rule of section

112(y)(2)(C) therefore purports to address conflicts between existing treaties and the Act that have not been identified by the staffs and to resolve them in favor of the Act. The overriding thrust of section 112(y)(2)(C) and the Staff Description's analysis is to assert the primacy of the Act over existing U.S. treaty obligations, except in the enumerated instances.

In the event that the Staff's analysis of treaty conflicts is incorrect, i.e., an independent tribunal would find the Act to conflict with a treaty obligation, section 112(y)(2)(C) would direct that the treaty obligation be overridden. For instance, notwithstanding the analysis in the Staff Description, it is not clear that the U.S. branch-level tax on excess interest is consistent with certain treaty provisions. If section 112(y)(2)(C) were enacted, however, it would be futile for a taxpayer to assert a claim that the branch interest tax was inconsistent with a treaty because section 112(y)(2)(C) would cause the branch interest tax to override the treaty. Moreover, there likely will be conflicts between the Act and treaty obligations which only will be identified in the future. In any such case, section 112(y)(2)(C) would direct that the treaty obligation be overridden.

Discussion

The Administration strongly opposes the "residual treaty override" of section 112(y)(2)(C). In letters from Secretary Baker to then Chairman Packwood on April 7, 1986 and July 31, 1986, and from Secretary Shultz to Chairman Packwood dated August 13, 1986, the Administration expressed to this Committee its objections to unilateral statutory overrides of U.S. treaties as a matter of principle and on tax and foreign policy grounds. We reiterate those objections here. In the context of the most substantial changes to our income tax laws since their inception, enactment of section 112(y)(2)(C) would evince a more flagrant disregard of our treaty obligations than any tax provision previously enacted. Moreover, it likely would introduce as many interpretive anomalies as it would solve.

In considering section 112(y)(2)(C) one should take account of the role that treaties play in the international commerce of the United States and the broader policy issues raised by the provision. The United States has in force 35 bilateral income tax treaties, including treaties with all of our major trading partners. More income tax treaties will be transmitted to the Senate for approval in coming months. As you know, Treasury staff, after detailed consultation with staffs of the tax-writing committees, the Joint Committee on Taxation, and the Senate Foreign Relations Committee, has been communicating proposed modifications to foreign governments to finalize many treaties the completion of which had been delayed pending passage of the Tax Reform Act. In addition to tax treaties, the United States is a party to commercial treaties, including treaties of "Friendship, Commerce and Navigation."

Our extensive tax treaty network is designed to encourage the free flow of investment capital and technology between the United States and its trading partners by mitigating possible international double taxation. This tax treaty network has served the United States well over the years and is an important element of our international economic policy. U.S. multinationals and other U.S. direct investors abroad are major beneficiaries of U.S. income tax treaties. Their principal benefit derives from reductions by our treaty partners in withholding tax rates on payments of dividends, interest, and royalties. They also benefit from the permanent establishment rules and the competent authority dispute resolution mechanism of U.S. tax treaties. In this way, tax treaties play an important role in enhancing the international competitiveness of U.S. business. Commerce Department data show that the book value of U.S. direct investment abroad has grown from $220 billion in 1980 to $260 billion in 1986. Approximately 75 percent of U.S. direct investment abroad was in countries having an income tax treaty with the United States.

The U.S. economy also benefits from the inflow of direct investment capital from residents of our treaty partners. Foreign direct investment in the United States has grown from $83 billion in 1980 to $209 billion in 1986.1/ In 1986, 94 percent of the foreign direct investment in the United States was by residents of U.S. treaty partners.

Tax treaties also provide a primary mechanism by which our tax administration can exchange information with its counterparts in treaty countries. This mechanism is invaluable in the United States' efforts to carry out one of the fundamental goals of tax reform -- to preserve the integrity and confidence in the tax system by ensuring that everyone pays his or her fair share of taxes.

1/ These Commerce Department data understate the value of U.S. direct investment abroad relative to foreign direct investment in the United States because they are based on book, not market, values. The U.S. investment abroad is more mature and, in market value terms, exceeds foreign investment in the United States to a greater extent than the Commerce data would suggest.

Our foreign trading partners are reacting with concern to section 112(y)(2)(C). The provision was the subject of discussion at a meeting of the Committee on Fiscal Affairs at the Organization for Economic Cooperation and Development ("OECD") on July 7 and 8, 1987. After considerable debate, in which the U.S. delegation declined to participate except to answer questions, the Committee on Fiscal Affairs adopted the following summary of its discussion:

> In discussion it was noted that, under the Technical Corrections Bill now before Congress, the amendments made by the United States Tax Reform Act of 1986 are to be effective notwithstanding any provision in any United States tax treaty. The United States has double taxation agreements with nearly all the Member states of the Organization for Economic Cooperation and Development (OECD). The Committee on Fiscal Affairs of the OECD was concerned about the increasing frequency with which in recent years, and particularly during the recent process of tax reform, the United States had sought unilaterally to override its own international agreements. This could only call into doubt the intentions of the United States when negotiating agreements and undermine the stated policy of OECD "to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations."

The Governments of Belgium, France, Germany, Great Britain, Luxembourg, and the Netherlands have each expressed to the Treasury Department their concerns regarding treaty overrides in the Act and in the bill, including the residual treaty override in section 112(y)(2)(C). Copies of these submissions, dated July 16, 1987, were sent to Senators Bentsen and Packwood. Other Governments have conveyed their concerns less formally. As Secretary Shultz said of unilateral treaty overrides generally in his letter of August 13, 1986, enactment of section 112(y)(2)(C) would be contrary to the interests of the United States. It would seriously damage the United States' credibility as a treaty partner, thereby making negotiation of tax and other commercial treaties more difficult in the future. It would be detrimental to our foreign relations interests.

The ambiguous and potentially broad scope of the "residual treaty override" provision makes it impossible to predict how grave a treaty violation may be. A material breach of a treaty would entitle the treaty partner to terminate or suspend the treaty in whole or part. (Vienna Convention on the Law of Treaties, Art. 60.) These potential effects would severely weaken the legal framework established by tax and commercial treaties to encourage efficient flows of investment capital between ourselves and our treaty partners.

While the authority of Congress to override treaties by legislation is undisputed for domestic law purposes, legal precedents have explored the reasons against exercise of that authority in cases where Congress has not clearly had the opportunity to weigh the policy implications of a particular override. The Supremacy Clause of the Constitution, Article VI, clause 2, provides that the Constitution, federal laws, and all treaties are the supreme law of the land. This has been interpreted to mean that federal law and treaties are equal. E.g., Whitney v. Robertson, 124 U.S. 190 (1888). As a matter of domestic law, later enacted legislation can take precedence over an inconsistent pre-existing treaty, and vice versa. Nevertheless, repeals by implication are not favored, whether the "repeal" is of a statute or a treaty, and a court will therefore seek to the maximum extent possible to interpret a treaty and a statute in a manner that gives effect to both.

Even when there is a nominal conflict in language between a treaty and a statute, a court may, in appropriate circumstances, decline to apply the later-in-time rule blindly. Respect for treaties has given rise to "a firm and obviously sound canon of construction against finding implicit repeal of a treaty in ambiguous Congressional action." Trans World Airlines, Inc. v. Franklin Mint Corp., 446 U.S. 243, 252 (1984). In Cook v. United States, 288 U.S. 102 (1933), the Supreme Court applied a 1924 treaty between the United States and Great Britain to limit a provision of the Tariff Act of 1930, stating that a treaty will not be deemed to be abrogated by a later statute "unless such purpose on the part of Congress has been clearly expressed." Because the relevant provision of the 1930 Tariff Act was a re-enactment of a provision of the Tariff Act of 1922, which preceded the treaty, and there was no evidence that the Congress or the Executive Branch contemplated a modification to the treaty, the Court declined to find that the re-enactment abrogated the treaty.

The policy reasons underlying the judicial solicitude for treaties, notwithstanding their equal weight with legislation, are self-evident. In subsequent legislation Congress modifies earlier acts of Congress. Treaties, however, involve the interests and reasonable expectations of another sovereign State. A principal purpose of tax and other commercial treaties is to provide certainty regarding the application of tax and other regulations to transactions governed by the laws of two States. In addition, unilateral abrogation of a treaty by subsequent legislation, though effective as a matter of domestic law, is a violation of international law. Vienna Convention on the Law of Treaties Art. 27.

We believe that the concerns that underlie the judicial reluctance to find implicit abrogations of treaties equally support opposition to section 112(y)(2)(C). For the non-judicial branches of government to insist that courts blindly apply the later-in-time doctrine to cases of unidentified conflicts reflects a lack of confidence in courts and a lack of regard for treaties. It also denies both the United States and its treaty partners the benefit of case-by-case consideration of how purported conflicts should be resolved in light of the purposes of the treaties and the relevant legislation.

We are aware of the concern that taxpayers, relying on Cook v. United States and similar cases, may take generally worded treaty provisions as a basis for tax return positions that would be contrary to the intended effect of the treaty, in the absence of specific language in the statute or the legislative history indicating that a provision of the Act is to prevail over treaties.2/ While we share the concern that treaties not be used inappropriately to circumvent the Congressional intent, we believe that section 112(y)(2)(C) is too blunt and costly an instrument for this purpose. The record of the courts in reconciling the policy concerns behind treaties and legislation is very good. We believe that case-by-case adjudication of treaty conflicts is far preferable to the approach that would be mandated under the bill. Accordingly, we recommend that the residual treaty override rule of section 112(y)(2)(C) be deleted.

2/ The House Ways and Means Committee Report to H.R. 3838 stated:

> Except as mentioned in the bill or this report, the committee is not aware of conflicts between any treaty and the changes (from the 1954 code as amended) that this bill makes. The committee intends that this bill be interpreted so as not to conflict with the policy embodied in treaties where possible so that the policy goals of both treaties and this bill can be carried out. The committee expects that such harmonious interpretations will be the rule rather than the exception. In any event, the committee is making substantive modifications to present law with clear policies in mind, and does not intend those policies to be defeated by literal interpretations of existing treaties.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 79. (Emphasis added.)

Section 112(y)(2) provides in part that section 701 of the Tax Reform Act (as it relates to the alternative minimum tax foreign tax credit) is to apply notwithstanding any contrary treaty obligation. Section 701 of the Act provides, in part, that the alternative minimum tax ("AMT") foreign tax credit shall be limited to 90 percent of a taxpayer's tentative minimum tax before it is reduced by the AMT net operating loss and foreign tax credit. When applicable, the 90 percent limitation on the AMT foreign tax credit would require that foreign income be subject to double taxation. In a letter from Secretary Baker to Chairman Packwood, dated July 31, 1986, the Administration expressed its opposition on policy grounds to the 90 percent limitation. We continue to believe that the 90 percent limitation is bad policy; we should not compound the error by causing the provision to override our treaty obligations. It is accepted international tax practice among major trading nations for the country of residence of a taxpayer to avoid double taxation of foreign income by means of a credit for foreign taxes or exemption of foreign income. This principle is embodied in Article 23 of the OECD's Model Convention for the Avoidance of Double Taxation With Respect to Taxes On Income and Capital and the United States' June 1981 draft Model Income Tax Treaty. The 90 percent limitation is inconsistent with our treaty obligation to provide a full foreign tax credit (subject to the limitation on the credit to the applicable U.S. tax on the income in question). Neither the Act nor the legislative history to the Act indicated that section 701 would be applied to override treaties. We do not believe it should. The bill should provide that section 701 of the Act will not apply to the extent inconsistent with a treaty.

Other Foreign Provisions

I will limit my remaining comments on the foreign provisions to two items which we believe should be addressed either in this bill or in another legislative initiative. These items involve the branch profits tax and passive foreign investment companies ("PFICs").

The branch profits tax is intended to collect a shareholder-level tax when the U.S. branch of a foreign corporation makes a deemed remittance to its headquarters office. If the foreign corporation is owned in whole or in part by U.S. persons, however, another shareholder-level tax often will be collected when the foreign office pays a dividend to its U.S. shareholders. The House bill provided a credit for the branch profits tax that would have reduced the likelihood of collecting two shareholder-level taxes, but the credit was not included in the final bill.

In recent weeks, the staff of the Treasury Department has held preliminary discussions with Congressional staff members on ways to amend the rules that apply to U.S. source income of foreign corporations with direct or indirect U.S. shareholders. One idea that has been discussed is a U.S. shareholder-level credit to take into account the U.S. shareholder-level tax that has already been collected on U.S. profits distributed by foreign corporations. We look forward to continuing those discussions. Although there are some difficult technical questions, I am confident that we can reach agreement on appropriate proposals.

Another subject of concern with respect to the foreign provisions of the Act relates to the scope of the operation of the PFIC provisions. The PFIC provisions cause U.S. shareholders of a foreign corporation that qualifies as a PFIC to be taxed currently on their proportionate share of the PFIC's earnings, whether those earnings are attributable to passive or active income of the PFIC. Under the Act, a company qualifies as a PFIC if it has either a certain level of passive income or a certain level of passive assets. We are concerned that the passive asset test operates to throw too broad a category of companies into PFIC status.

We believe that the PFIC provisions should be targeted to cases where a U.S. person's investment in the stock of a foreign corporation has the predominant effect of allowing the accumulation offshore of passive investment income. In this regard, we believe that the level of a foreign corporation's passive assets generally is not relevant, except to the extent that the assets either generate current passive income to the corporation or reflect the accumulation of current passive income within a lower tier corporation. The Act currently treats foreign corporations as PFICs under the passive asset test without regard to whether the passive assets in question are reflective of the excessive accumulation of current passive income within the chain. The result in many cases is to subject U.S. persons to current taxation on the active income of foreign corporations in which they hold shares, even though the foreign corporation is not predominantly engaged directly or indirectly in the accumulation of passive income.

The bill contains one amendment to the passive asset test that is designed to mitigate this effect, but only in very limited circumstances. We believe that it would be appropriate to study the passive asset test further to determine whether it could be amended to prevent the PFIC provisions from applying too broadly.

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Low-Income Housing Tax Credit -- 10-Year Holding Period Requirement for Acquisition of an Existing Building

Background

The Tax Reform Act introduced a new low-income housing tax credit that may be claimed with respect to certain expenditures incurred by owners of qualified residential rental buildings. The credit is claimed annually, generally for a period of 10 years, beginning with the year a qualified building is placed in service by the taxpayer. For buildings placed in service in 1987, the annual tax credit percentage for new construction and rehabilitation expenditures for non-federally subsidized buildings is 9 percent.3/ A lesser tax credit percentage (4 percent for buildings placed in service in 1987) is available for new construction and rehabilitation expenditures for federally subsidized buildings and for the acquisition cost of existing buildings that are acquired by purchase from an unrelated party.4/ No tax credit is available, however, for the acquisition cost of an existing building unless there is a period of at least 10 years between the taxpayer's purchase of the building and the later of (a) the date the building was placed in service by the prior owner or (b) the date of the most recent prior "nonqualified substantial improvement" of the building.

In the case of certain existing buildings that are federally assisted, the 10-year holding period requirement may be waived by the Secretary of the Treasury, after consultation with the Secretary of Housing and Urban Development ("HUD") and the Secretary of Agriculture. Waivers may be granted only if the Secretary of the Treasury determines that a waiver is necessary:

(i) to avert an assignment of a mortgage secured by property in the project to HUD or the Farmers' Home Administration ("FmHA");

3/ For buildings placed in service in subsequent years, the tax credit percentage is to be determined by the Treasury Department to yield a discounted present value equal to 70 percent of the expenditures eligible for the credit over the 10-year credit period.

4/ For buildings placed in service in subsequent years, the tax credit percentage is to be determined by the Treasury Department to yield a discounted present value equal to 30 percent of the expenditures eligible for the credit over the 10-year credit period.

(ii) to avert a claim against a federal mortgage insurance fund, HUD, or FmHA with respect to a mortgage secured by property in the project; or

(ii) to the extent provided in regulations, by reason of other circumstances of financial distress.

No waiver may be granted if a prior owner of the building was allowed a low-income housing tax credit. Waivers are available only with respect to buildings that are substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, sections 221(d)(3) or 236 of the National Housing Act of 1934, or section 515 of the Housing Act of 1949.

Description of Section 102(1)(7) of S. 1350

Section 102(1)(7) of the bill would amend section 42(d)(6) of the Code to restrict the Secretary of the Treasury's authority to waive the 10-year holding period. Waiver authority would be limited to circumstances in which a waiver is necessary to avert an assignment of a mortgage to HUD or FmHA or to avert a claim against a federal mortgage insurance fund, HUD, or FmHA. The existing grant of authority to the Treasury Department to provide by regulations for a waiver in other circumstances of financial distress would be repealed.

Discussion

The Treasury Department generally supports the many technical corrections included in the bill relating to the low-income housing tax credit. These technical corrections are generally designed to make the credit more administrable for taxpayers, State housing agencies, and the Internal Revenue Service. The corrections will further the purpose of the credit to help preserve the stock of existing low-income housing and stimulate new investment in low-income housing. With these objectives in mind, the Treasury Department opposes the total deletion of authority to waive the 10-year holding period requirement in circumstances other than those that involve the potential assignment of a mortgage to a federal agency or a claim against a federal mortgage insurance fund. The Treasury Department and HUD believe that the Treasury Department should retain authority to waive the 10-year holding period requirement in the limited circumstance when such a waiver is necessary to prevent federally assisted and federally insured low-income buildings from being converted to serve non-low-income tenants.

In general, imposition of the 10-year holding period requirement on taxpayers acquiring existing building serves to preclude tax-motivated churning of existing buildings while encouraging new owners of older buildings to maintain their low-income character. The authority granted to the Treasury Department to waive the 10-year holding period requirement is intended to reduce the federal government's financial exposure with respect to federally assisted buildings. Allowing a waiver of the 10-year holding period requirement provides an incentive to taxpayers to acquire, operate, and maintain existing federally assisted buildings for low-income tenants, thereby eliminating any risk of foreclosure or other event requiring the commitment of federal funds. Thus, the waiver authority furthers existing federal low-income housing programs by protecting federal financial commitments and preserving the stock of federally assisted low-income buildings.

In addition to the two circumstances in which the bill leaves undisturbed Treasury's waiver authority, we believe that waiver authority should be retained in a limited third circumstance. Under sections 221(d)(3) and 236 of the National Housing Act of 1934, HUD provided interest reduction payments for the construction and substantial rehabilitation of low-income housing projects. Over 5,000 low-income housing projects (containing approximately 600,000 units) were federally assisted under these programs, most of which were completed in the late 1960s and early 1970s. Under these programs, many owners are entitled to prepay their mortgages after 20 years without HUD approval and, upon prepayment, would no longer be obligated to provide low-income housing. Many of the existing HUD-assisted projects are nearing the end of the 20-year obligation period. HUD is now considering various measures that may be taken to encourage project owners who might prefer to retain units for low-income tenants. One appropriate measure would be to allow a waiver of the 10-year holding period requirement, which would enable a purchaser to preserve a low-income building with the assistance of the low-income housing credit. Thus, in this limited circumstance in which federally assisted and federally insured low-income buildings would otherwise be converted to serve non-low-income tenants, a narrowly drafted technical correction to the waiver authority would be appropriate.

Treatment of Certain Installment Sales Under Passive Loss Rules

Background

Section 501(a) of the Tax Reform Act of 1986 added new section 469 to the Code, effective for taxable years beginning after December 31, 1986. Section 469(a) prevents the current use of a passive activity loss or a passive activity credit. A taxpayer's passive activity loss and passive activity credit are net amounts, representing the excess of aggregate losses, or credits, from passive activities for the taxable year over the aggregate income from, or regular tax liability allocable to, passive activities for the taxable year. Thus, an increase in income from passive activities reduces the amount of the losses or credits that are disallowed by the passive loss rule.

Despite the importance of identifying income from passive activities, the only guidance in the statute as to the treatment of items of income as income from passive activities is negative. Thus, section 469(e) provides that items of portfolio income (such as interest, dividends, annuities, and royalties not derived in the ordinary conduct of a trade or business) and earned income shall not be taken into account in determining the income or loss from a passive activity.

Following the enactment of the Tax Reform Act, substantial uncertainty existed regarding what income could be treated as income from a passive activity. Three questions were frequently asked relating to the treatment of gain from sales or exchanges of interests in activities. The first question was whether gain realized upon a disposition of an interest in a passive activity could ever be treated as income from a passive activity.5/ The second question was whether the result would be different if recognition of the gain were deferred under the installment method. The third question was whether, assuming gain on disposition of a passive activity is considered to be passive income, gain recognized on the installment method with respect to an activity sold prior to the effective date of section 469 would also be considered passive income if the activity would have been treated as a passive activity had section 469 been in effect for the year of the sale.

In response to these queries, on January 20, 1987, the Internal Revenue Service issued Notice 87-8 (1987-3 I.R.B. 11), explaining the treatment under section 469 of gain from sales or exchanges of interests in activities. Notice 87-8 stated that temporary regulations under section 469 would treat gain from the sale of an interest in an activity in a taxable year beginning after 1986 as derived from a passive activity if income from the activity for the year would be treated as income from a passive activity, without regard to whether the gain is reported on the installment method. Notice 87-8 also stated that gain from a

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5/ Some practitioners suggested that it was unclear whether such gain could be considered income "from the activity" since the gain arose from the disposition, rather than the operation, of the activity. Section 469(g), which provides special rules governing the treatment of losses upon certain dispositions of interests in passive activities, refers to (cont.)

sale in a taxable year beginning before 1987 that is recognized on the installment method in a taxable year beginning after 1986 is not income from a passive activity for purposes of section 469, regardless of whether the activity would have been treated as a passive activity in the year of the sale had section 469 been in effect.

Description of section 105(a)(10) of S. 1350

Under section 105(a)(10) of the bill, if gain is recognized in a taxable year beginning after December 31, 1986, from a sale or exchange of an interest in an activity in a taxable year beginning before January 1, 1987, and if the activity would be treated as a passive activity if the taxpayer held the activity for its first taxable year beginning after December 31, 1986, the gain will be treated as income from a passive activity for purposes of section 469.

Discussion

As discussed in detail below, we believe the position taken in Notice 87-8 is fully consistent with the language of section 469 and the effective date provisions of section 501 of the Tax Reform Act. Moreover, we believe the treatment of installment gains provided in Notice 87-8 avoids significant administrative difficulties and is strongly supported by the purpose of the passive loss rules to prevent the sheltering of positive income sources. Accordingly, the Treasury Department opposes section 105(a)(10) of the bill.

Under the effective date provisions of the Act section 501, the passive loss limitation of section 469 first applies for taxable years beginning after 1986. In general, the basic provisions of the passive loss limitation characterize items of

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". . . any loss from such activity . . . (and, in the case of a passive activity for the taxable year, any loss realized on such disposition) . . . ." The parenthetical implies that a loss realized on the disposition of an activity is not a loss "from" the activity and that, similarly, a gain realized on the disposition of an activity may not be income "from" the activity. Moreover, although the phrase "income or gain" is used elsewhere in section 469, only the word "income" is used in section 469(d)(1) in defining the term "passive activity loss." Finally, the Senate Finance Committee Report (S. Rep. No. 99-313, May 29, 1986, p.725) indicates that, where losses from an activity have been suspended, gain realized upon a disposition of an interest in the activity should be taken into account in determining when the suspended losses are allowed, but leaves unclear whether any net gain (i.e., gain in excess of the suspended losses) may be offset by losses from other passive activities.

income, loss, and credit by reference to the taxpayer's activities in the taxable year in which the items arise, and ignore events occurring in any prior taxable year.6/

This general rule is proved by the specific exceptions provided for in the statute. For example, section 469(f)(1)(C) provides that, where a passive activity becomes an active business, losses suspended in prior years must still be treated as losses from a passive activity to the extent they exceed the current income from the activity. This exception from the general rule is necessary to prevent treatment of the suspended losses (which are treated under section 469(b) as current deductions arising in the activity) as deductions from an active business, allowable without limitation.

Similarly, section 501(c)(2) of the Tax Reform Act provides that section 469 does not apply to any loss, deduction, or credit carried to a taxable year beginning after 1986 from a taxable year beginning before 1987. Without this special rule, a loss, deduction, or credit carried forward from a pre-1987 year under the at-risk limitation (section 465), or under the basis limitations applicable to partnerships and S corporations (sections 704(d) and 1366(d), respectively), would be subject to the passive loss rules if, when first allowed under the applicable limitation, the item were treated as arising in an activity now treated as a passive activity. The inclusion of this special transitional rule suggests that, unless otherwise provided in the statute, items of income, deduction, and credit are characterized by reference to the nature of the activity in which they arise for the taxable year in which (but for section 469) they are taken into account on the taxpayer's return.

Given the above, we believe the statute may appropriately be read to treat deferred gains from pre-1987 sales as non-passive income, since, for 1987 and subsequent taxable years, there is no passive activity from which the gain can be considered as arising.7/ On this reading, the fact that there was an activity

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6/ Under section 469(d)(1), the passive activity loss for the taxable year is determined by netting the aggregate income and losses from all "passive activities for the taxable year."

7/ We are aware of a line of cases holding that, when a taxpayer elects to defer gain from an installment sale, the taxpayer is subject to the risk that the law applicable to the deferred gain may change prior to receipt of the payments. See, e.g., Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938). We find in these cases no implication that, where a fundamental change in the law provides for the aggregation of (cont.)

in a prior year that might have been treated as a passive activity had section 469 been in effect in that year is simply not relevant.8/

In addition to the technical arguments described above, we believe that considerations of tax administration and tax policy strongly support the position taken in Notice 87-8. One of the significant advantages of the general approach taken in section 469, namely, the characterization of income and loss for a taxable year based on the nature of the income or loss producing activity in that year, is that it is generally unnecessary to inquire into the nature of an activity or the taxpayer's involvement in the activity in prior years. Section 105(a)(10) of the bill, however, would require this inquiry in the case of installment sales in prior years of interests in activities claimed by the taxpayer to have been "passive activities" in such years.

In many cases, an inquiry into the status of an activity in a prior year will entail significant factual controversies. Under section 469, a trade or business activity in which the taxpayer does not materially participate is a passive activity. Where a taxpayer sold his interest in a business activity several years ago in an installment sale, section 105(a)(10) of the bill provides a significant incentive for the taxpayer to claim that his participation in the year of the sale did not rise to the level of "material participation," and that the activity was

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certain types of income and loss from activities in taxable years beginning after a certain date, deferred installment gains from dispositions of similar activities in prior taxable years must be taken into account.

8/ Under this analysis, deferred gain from an installment sale occurring in a taxable year beginning after 1986 could also be treated as non-passive income. Notice 87-8, however, states that, where the taxpayer sells an interest in a passive activity in a post-1986 installment sale, gain recognized in years subsequent to the year of the sale will be treated as passive income. Although we do not believe this result necessarily follows from literal application of the provisions of section 469, we believe section 469 is appropriately interpreted to provide that, in general, gain from activities that are conducted after 1986 as passive activities, and are thus subject to the passive loss restrictions, is passive income. To the extent section 469 does not directly provide for this result with respect to post-1986 installment sales, section 469(k) grants to the Secretary the authority to prescribe any regulations necessary or appropriate to carry out the purposes of section 469.

therefore a passive activity in the year of the sale.9/ Although taxpayers bear the burden of proving lack of material participation, the outcome in such cases would not generally be free from doubt, leaving taxpayers with possible reporting positions and the Internal Revenue Service with a difficult task on audit. We question whether a statutory provision creating such difficult factual issues reflects a wise policy choice.

Moreover, treating as passive income deferred gain from a pre-1987 installment sale would be inconsistent with the structure and purposes of the passive loss provisions. The Conference Report accompanying the Tax Reform Act identifies the "underlying purpose of the passive loss provision" as "preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities." (H. Rep. 99-841, September 18, 1986, p. II-147.) The statute and legislative history make plain that non-shelterable positive income sources include not only earned and portfolio income, but also income from other activities that would characteristically not be subject to the restrictive effects of the passive loss rules. Thus, while section 469 directly excludes earned income and interest, dividends, and other portfolio income from the calculation of passive income, it also authorizes Treasury by regulation to treat income from certain formally passive activities as non-shelterable, non-passive income. The examples provided in the Conference Report as possibly appropriate instances for the exercise of such authority include activities meeting the definition of a passive activity, but either not likely to produce losses (e.g., a ground lease producing rental income without significant expense) or having produced losses not subject to restriction under the passive loss rules (e.g., activities previously generating active losses that are intentionally transformed into passive activities when they generate income).

From the above analysis we think it is clear that passive income should not include income from activities that cannot generate losses subject to the passive loss limitation. Since an activity disposed of before 1987 cannot be subject to the passive loss limitation, an installment note from the disposition of such an activity is appropriately characterized as a positive income source not shelterable by passive losses.

9/ Difficult factual issues may also arise where a taxpayer claims that an activity sold on the installment method in a prior year was passive activity by virtue of being a rental activity. For example, identification of an activity as a rental activity will involve an examination of the level of services provided in the activity and the extent to which the provisions of services constituted a separate activity.

We would also note that section 105(a)(10) of the bill cannot be justified, as some have suggested, as a mechanism to mitigate the effect of the passive loss rules on pre-1987 investments. Although some taxpayers holding pre-1987 investments subject to the passive loss limitation might also have installment notes from sales of pre-1987 activities, this would not be consistently true. Thus, many taxpayers subject to passive loss restrictions on pre-1987 investments would not hold pre-1987 installment notes and consequently would receive no benefit from section 105(a)(10). Many other taxpayers would be benefited by section 105(a)(10), but would not hold pre-1987 investments subject to the passive loss limitation. This latter group of taxpayers would, of course, have an incentive to seek out new tax shelter investments in order to offset the passive income from their pre-1987 installment notes.

Finally, we do not believe that section 105(a)(10) of the bill can be justified on the grount that some taxpayers sold activities in late 1986 in asserted reliance that gain recognized in 1987 and subsequent years would be treated as income from a passive activity. The intended treatment of pre-1987 installment sales under the Tax Reform Act was at best ambiguous, and taxpayers entering into transactions on the advice of counsel should have been apprised of the attendant uncertainties. To elevate such uncertainties to a basis for statutory relief would set an unfortunate precedent.

In sum, the Treasury Department continues to believe that the position taken in Notice 87-8 with respect to pre-1987 installment sales was sound as a matter of statutory interpretation, and is supported by important administrative and policy concerns. The practical effect of section 105(a)(10) of the bill would be to create administrative difficulties for the Internal Revenue Service and to bestow a windfall benefit on taxpayers who transferred "burned-out" tax shelter investments by installment sale prior to 1987.

Treatment of Foreign
Currency Gains for Purposes of Section 851(b)(3)

Background

In order to qualify to be taxed under the pass-through rules applicable to regulated investment companies ("RICs"), a corporation must satisfy numerous requirements, including two that limit the types of income that can be received by a RIC. Section 851(b)(2) of the Code requires that at least 90 percent of the gross income of the RIC be derived from interest, dividends, payments with respect to securities loans, gains from the disposition of securities or foreign currencies, or certain other income. Section 851(b)(3) of the Code (the so-called "short-short" rule) requires that less than 30 percent of the gross income of the RIC be derived from the disposition of securities held for less than three months. These restrictions on RIC income are intended to prevent RICs from engaging in an active business.

Section 653 of the Tax Reform Act amended section 851(b)(2) to add foreign currency gains (and gains from forward and futures contracts thereon) to the list of qualifying income of a RIC. The Treasury Department was granted regulatory authority to exclude from qualifying income foreign currency gains which are not ancillary to the company's principal business of investing in securities. This grant of regulatory authority was adopted to provide a means of preventing RICs from engaging in a business other than securities investment while recognizing the difficulty of prescribing precise rules to distinguish between permissible and impermissible foreign currency gains.

Description of Section 106(n)(2) of S. 1350

Section 106(n)(2) of the bill would amend section 851(b)(3) of the Code to add to the categories of income subject to the "short-short" rule gains from the disposition of (a) forward and futures contracts or (b) except as provided in regulations, foreign currency. The provision is proposed to be effective for taxable years beginning after October 22, 1986.

Discussion

As we have testified in the past, although RIC treatment should be available only to entities that are not engaged in an active business, we believe that the "short-short" rule is not essential to this purpose, forces RICs to make uneconomic decisions, and needlessly imposes substantial compliance costs on RICs. While we do not wish to reopen the issue of whether the "short-short" rule should be repealed, we do not believe that the scope of the "short-short" rule should be expanded.

The expanded scope of the "short-short" rule as proposed in the bill can be illustrated by two examples. First, if a RIC owning a pound denominated debt instrument that pays interest quarterly accrues interest on the debt instrument daily, it appears that any foreign currency gain resulting from currency fluctuations between the time the interest was accrued and the time it was received would be treated as a "short-short" gain under the bill. Second, if a RIC holds cash in a yen denominated demand deposit for a temporary period, e.g., prior to the purchase or following the sale of a yen-denominated stock, it appears that any foreign currency gain resulting from currency fluctuations during the temporary period the proceeds are held in the demand deposit would be treated as a "short-short" gain under the bill.

Whatever the utility of the "short-short" rule in preventing RICs from engaging in short-term speculation or becoming "too" active, these interests do not appear even arguably to be served in the above examples. Indeed, the rule may force some RICs to increase their level of trading activity and exposure to risks of short-term currency fluctuations since, in order to reduce "short-short" gains, they may be required to convert interest receivables and temporary cash investments into dollar denominated investments, and to reconvert such investments into foreign currency denominated investments when they reinvest such amounts.

Concerns regarding the potential ability of RICs to engage in currency speculation were considered during the development of the Tax Reform Act, and were addressed by the grant of regulatory authority in section 851(b)(2) described above. We believe that this regulatory authority is adequate to address concerns about RICs misusing their broadened ability to realize foreign currency gains. Accordingly, we do not believe that section 851(b)(3) should be amended to subject foreign currency gains to the "short-short" rule, as proposed by the bill.

If the provision subjecting foreign currency gains to the "short-short" rule is retained in the bill, we would recommend that certain changes be made. As was recognized in connection with the amendment of section 851(b)(2), attempting to develop administrable rules that distinguish between permissible and impermissible foreign currency gains is a difficult task. We believe it would be preferable for the regulations, with appropriate guidance in the statute and legislative history, to identify the foreign currency gains that should be subjected to the "short-short" rule, rather than the gains that should be excluded from the rule. If this change is not made, the provision should be given only prospective effect, so that RICs do not face retroactive disqualification and the Treasury Department has an opportunity to issue timely regulations. Finally, forward and future contracts in foreign currency should be treated in the same manner as foreign currency gains for purposes of section 851(b)(3). That is, any regulatory authority to create exceptions from the "short-short" rule should extend to forward and futures contracts in foreign currency.

This concludes my prepared remarks. I would be pleased to answer any questions.

STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM THE STATE OF ALASKA

Senator MURKOWSKI. Thank you very much, Mr. Chairman. I appreciate the opportunity to appear here this morning. My topic will be a little lighter than the statement previously made by the Assistant Secretary.

As you may or may not know, last session, in recognition of the need for greater tax equity, I supported a move, along with a majority of the Senate, to remove millions of low income people from the tax rolls when we passed the Tax Reform Act of 1986. That was, of course, one of the reasons that I supported the tax reform.

Now there are some others who should have been included in that group that were not, and that brings me before you, Mr. Chairman, this morning. I now find that the combined effect of several changes in the Tax Reform Act will subject nearly a quarter of the children in our State of Alaska—approximately 130,000, which equates to a quarter of our population—under the age of 14. And, Mr. Chairman, the significance of the age of 14 was set under the Tax Reform Act, and it relates to a situation previously where parents were shifting income, but that certainly is not the case in Alaska where every resident qualifies—and qualifications is 30 days within the State—and is entitled to receive a dividend from the operation of the State Permanent Fund.

Now all these children under the age of 14 obviously fall into the low income category. It is my belief that the effect of the current tax law was unintended to include this group. I would ask support for an amendment to correct this.

As the chairman knows, the Tax Reform Act requires children under the age of 14 to file a return and pay a tax on unearned income of more than $500.00 if they are claimed as dependent on another's tax return. Unlike in the past, those children no longer may offset the tax on that income due to the loss of the full use of the standard deduction, itemized deductions and personal exemptions.

In my State, Mr. Chairman, each year children are entitled to receive, as I have indicated, an Alaska Permanent Fund dividend from the operation of the Permanent Fund. The Fund was set up on the basis of taking the royalties from oil in trust—this goes back to 1976—primarily the yield off the investment was intended to provide for Alaska's future in various ways and one of the beneficiaries are obviously our young people.

The amount of the dividend, of course, varies from year to year, depending on the Fund's earnings. As I indicated earlier in my statement, approximately 130,000 children under the age of 14 receive a dividend of $556.00 this last year. It is expected to be increased to roughly $700.00 next year. This is used by those children to provide for a college education and other purposes.

Now the dividend is considered unearned income for tax purposes. And this year, under the new Act, Alaska's children who have no other income other than the Alaska Permanent Fund dividend would have to file and pay a tax of roughly $22.00. Now I need not reflect on what the cost of processing is, but to file and have to pay a tax of $22.00 hardly seems to be worth the effort.

Needless to say, they are included under the current interpretation of the tax law. It is my feeling that this places an unnecessary burden on the young people in my State. The cost incurred in collection, I think, exceed the revenue collected.

So my request is similar to another problem corrected by Congress at the request—and my request in 1982—when it raised the dollar threshold amount triggering the filing of a tax return to a dependent to $1,001.00. This was done in recognition of the unique tax consequences associated with the Alaska Permanent Fund dividend. And the committee was understanding and did allow an exemption at that time.

So, in conclusion, Mr. Chairman, I would add that the effect of the tax Act's changes, as unintended as they may have been in this case, is also not in keeping with one of the purposes for those changes, and that is to prevent the tax sheltering of income through the shifting of income from a parent to a child in a lower tax bracket, as I mentioned. The dividend falls outside the context of income shifting. It is a State benefit given directly to each child and it is not a part of a family tax planning scheme.

Because of these reasons, I would respectfully ask the committee to accept my amendment to allow dependent children under the age of 14 who do not itemize deductions to increase their limited $500 standard deduction by the amount of their Alaska Permanent Fund dividend, which, as I have mentioned, varies from year to year.

The amendment is limited to only those children with virtually no income other than the Alaska Permanent Fund dividend. I think it is a modest request in relation to the disproportionate burden on Alaska's children. And I think the question is quite legitimate: How does the government come out on this? What is the potential revenue loss? Revenue loss, obviously, is more than offset by the processing and enforcement. As I indicated, the tax would be approximately $22 for most of the children and it is anybody's guess what the actual processing costs are associated with reviewing returns. We have attempted to obtain this information and have not been able to get a good fix on what it cost the government to process returns, let alone enforcement.

So I would respectfully request consideration on this. We have met with the staff. There seems to be a concern over the definition of what a technical amendment specifically must meet as far as the test is concerned, and as a consequence, the effect of the new tax changes on Alaska's children, in my opinion, is certainly an unintended oversight that needs correction. The staff has said—I believe it is correct—that it is not a technical amendment strictly. We happen to think it is in the sense of the oversight.

So I would urge the committee in its wisdom to reflect on the merits of this request; the justification of the cost to the government, the offset of any revenue that may be lost is modest in comparison to the processing fees and would urge favorable consideration.

Mr. Chairman, I would be happy to answer any questions you may have.

Senator BAUCUS. Thank you very much, Senator.

I am curious though though. What has historically been the amount of royalties paid to children under age 14 under the Alaska Permanent Fund?

Senator MURKOWSKI. Well here again it has been as high as $1,000 and as low as $350. And it varies, depending on the yield off the investment of the principal in any one year. And the State Legislature meeting with the Governor sets the amount of the dividend, depending on what the other priorities for utilization of the yield are. So it varies. In times of declining oil prices, obviously there is more pressure on the balance for other purposes in the State. But this is one of the high priorities, and it has been justified by the realization that we are dealing with revenues that are coming from a nonrenewable resource, namely oil.

The State maintains a permanent fund, so it is the realization of the yield.

Senator BAUCUS. But it has been between $300 and some and a thousand dollars?

Senator MURKOWSKI. $300 is low and $1,000 is high.

Senator BAUCUS. All right.

Senator MURKOWSKI. So that is roughly the amount we are talking about.

Senator BAUCUS. Thank you very much. We appreciate your apperance here and your contributions.

Senator MURKOWSKI. Thank you very much, Mr. Chairman. I appreciate the opportunity to be here this morning.

Senator BAUCUS. The next witness very patient Senator Dodd.

Senator MURKOWSKI. I know he will support my position. I would support his if he had a Permanent Fund.

[The prepared written statement of Senator Murkowski follows:]

STATEMENT BY SENATOR MURKOWSKI FOR THE JULY 22, 1987 SENATE FINANCE COMMITTEE HEARING ON THE TECHNICAL CORRECTIONS TAX BILL TO THE TAX REFORM ACT OF '86.

MEMBERS OF THE SENATE FINANCE COMMITTEE:

LAST SESSION, IN RECOGNITION OF THE NEED FOR GREATER TAX EQUITY, WE REMOVED MILLIONS OF LOW-INCOME PEOPLE FROM THE TAX ROLLS WHEN WE PASSED THE TAX REFORM ACT OF '86. THAT WAS ONE OF THE PRIMARY REASONS WHY I SUPPORTED TAX REFORM.

I NOW FIND THAT THE COMBINED EFFECT OF SEVERAL CHANGES IN THE TAX REFORM ACT WILL SUBJECT OVER 1/4 OF ALASKA'S POPULATION, ALL OF THEM CHILDREN UNDER THE AGE OF 14, TO A NEW TAX AND FILING REQUIREMENT, EVEN THOUGH NEARLY ALL OF THEM ARE OF LOW-INCOME. I BELIEVE THAT THIS EFFECT WAS UNINTENDED, AND I ASK FOR YOUR SUPPORT FOR AN AMENDMENT TO CORRECT THIS.

THE TAX REFORM ACT REQUIRES CHILDREN UNDER THE AGE OF 14 TO FILE A RETURN AND PAY A TAX ON UNEARNED INCOME OF MORE THAN $500, IF THEY ARE CLAIMED AS A DEPENDENT ON ANOTHER'S TAX RETURN. UNLIKE IN THE PAST, THOSE CHILDREN NO LONGER MAY OFFSET THE TAX ON THAT INCOME DUE TO THE LOSS OF THE FULL USE OF THE STANDARD DEDUCTION, ITEMIZED DEDUCTIONS, AND PERSONAL EXEMPTION.

EACH YEAR ALASKA CHILDREN ARE ENTITLED TO RECEIVE AN ALASKA PERMANENT FUND DIVIDEND FROM THE ALASKA PERMANENT FUND. THE ALASKA PERMANENT FUND IS A STATE ROYALTY OIL TRUST SET UP IN 1976 TO PROVIDE FOR ALASKA'S FUTURE. THE AMOUNT OF THE DIVIDEND VARIES FROM YEAR TO YEAR DEPENDING ON THE FUND'S EARNINGS. LAST YEAR 129,455 CHILDREN UNDER THE AGE OF 14 RECEIVED A DIVIDEND OF $556. THIS YEAR, IT IS EXPECTED TO BE ROUGHLY $700.

THE DIVIDEND IS CONSIDERED "UNEARNED INCOME" FOR TAX PURPOSES. THIS YEAR UNDER THE NEW TAX ACT, ALASKA CHILDREN WHO HAVE NO INCOME OTHER THAN AN ALASKA PERMANENT FUND DIVIDEND WILL HAVE TO FILE AND PAY A TAX OF ROUGHLY $22.00.

NOT ONLY DOES THIS PLACE AN UNNECESSARY BURDEN ON CHILDREN, BUT IT IS HIGHLY LKELY THAT THE COSTS INCURRED IN COLLECTION MAY EXCEED THE REVENUE COLLECTED!

MY REQUEST IS SIMILAR TO ANOTHER PROBLEM CORRECTED BY CONGRESS AT MY REQUEST IN 1982 WHEN IT RAISED THE DOLLAR THRESHOLD AMOUNT TRIGGERING THE FILING OF A TAX RETURN OF A

DEPENDENT TO $1001. THIS WAS DONE IN RECOGNITON OF THE UNIQUE TAX CONSEQUENCES OF THE ALASKA PERMANENT FUND DIVIDEND.

FINALLY, I MIGHT ADD THAT THE EFFECT OF THE TAX ACT'S CHANGES, AS UNINTENDED AS IT MAY HAVE BEEN IN THIS CASE, IS ALSO NOT IN KEEPING WITH ONE OF THE PURPOSES FOR THOSE CHANGES -- TO PREVENT THE TAX SHELTERING OF INCOME THROUGH THE SHIFTING OF INCOME FROM A PARENT TO A CHILD IN A LOWER TAX BRACKET. THE DIVIDEND FALLS OUTSIDE THE CONTEXT OF INCOME SHIFTING. IT IS A STATE BENEFIT GIVEN DIRECTLY TO A CHILD THAT IS NOT PART OF A FAMILY TAX PLANNING SCHEME.

BECAUSE OF THESE REASONS, I ASK THE COMMITTEE ACCEPT MY AMENDMENT TO ALLOW DEPENDENT CHILDREN UNDER THE AGE OF 14 WHO DO NOT ITEMIZE DEDUCTIONS TO INCREASE THEIR LIMITED $500 STANDARD DEDUCTION BY THE AMOUNT OF THEIR ALASKA PERMANENT FUND DIVIDEND.

MY AMENDMENT IS LIMITED TO ONLY THOSE CHILDREN WITH LITTLE OR NO INCOME OTHER THAN AN ALASKA PERMANENT FUND DIVIDEND. I BELIEVE THAT IT IS A MODEST REQUEST IN RELATION TO THE DISPROPORTIONATE BURDEN ON ALASKA'S CHILDREN. THE JOINT TAX COMMITTEE ESTIMATES A REVENUE LOSS OF ONLY $1 MILLION FOR FY '88. BUT, IT MAY VERY WELL BE "REVENUE-NEUTRAL" IF ONE DEDUCTS ENFORCEMENT COSTS.

I THANK THE COMMITTEE FOR ITS CONSIDERATON ON THIS AND OFFER TO YOU WHATEVER ASSISTANCE THAT MAY BE NEEDED.

STATEMENT OF HON. CHRISTOPHER J. DODD, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator DODD. Mr. Chairman, you have been patient and I hope I haven't caused you any delay by being a few minutes late in being here this morning.

What I would like to do, Mr. Chairman, if I could is I have a short statement, and then I have a foreign language translation, which should be a more technical description of what I am proposing here to the committee, and I will submit that. And there are some graphs and charts that get rather detailed, because what I am talking about is a rather esoteric proposition. It is not a new transition rule, Mr. Chairman, but an amendment to one of the transition rules, the so-called "Fresh Start" transition rules. And I would like to propose to the committee an amendment to that proposition, which I will explain.

First of all, let me thank you, Mr. Chairman, and the committee for giving me an opportunity to come before you this morning. I am here to express, as I mentioned, a concern about what I can perceive to be a substantial inequity in the Tax Act of 1986 that I believe should be corrected through the amendment to S. 1350.

Inequity, Mr. Chairman, arises from the transition rules regarding the implementation of new discounting rules applicable to property and casualty insurance companies. These rules are referred to, as I have said, to "Fresh Start" rules. The 1986 Act "Fresh Start" rules treat otherwise identically situated property and casualty insurance companies differently, depending on whether or not a company previously discounted loss reserves as now mandated for everyone under the Tax Act.

Quite unfairly, a company that previously discounted reserves is disadvantaged by the "Fresh Start" rules in comparison to the company which is now only beginning to discount. Specifically, if two property/casualty insurers have identical reserve liabilities, but one previously discounted loss reserves on its annual statement and the other did not, the company that has been discounting will receive a substantially smaller fresh start than its competitor.

The competitive concerns associated with this inequitable treatment are apparent, I think. Attachment A, which I will submit, Mr. Chairman, to my statement is an illustration of the inequity and statutory language that would address it.

I believe that it is appropriate to address this problem in the technical corrections bill. The change that I am asking you to consider is not a new transition rule, as I mentioned, but rather an amendment to the transition rule contained in the 1986 Act.

I am, of course, aware of one of the primary concerns that I know the committee has is what the revenue impact of such a proposal that I make, or any other proposal for that matter, would be. While I believe that the fairness aspects of this matter independently justify addressing the matter in S. 1350 without regard to revenue considerations, I also believe that the proposed amendment properly should be treated as having no revenue effect.

The proposed amendment would conform the statute to the method of estimating the cost of the fresh start benefit at the time of the enactment of the 1986 Act. Attachment B to my statement is a memorandum which discusses this point in detail. Very briefly, Mr. Chairman, I would address that last point on the revenue impact, that what I would assume to be the major question, the revenue.

If you look at the revenue impact, it is my understanding that the Joint Committee on Taxation has taken the position that Section 105(a)(10) of S. 1350 has no revenue effect because the change would conform the statute to the assumption under which the Joint Committee on Taxation originally estimated the revenue effect of the passive loss rules. I believe this situation that I have described to you here is conceptually identical to the situation concerning the proposed amendment because the amendment would conform the statute to the assumptions under which the Joint Committee on Taxation originally estimated the revenue effect of the fresh start rules.

Staff, as I said, it gets rather esoteric, but our considered judgment is that this has no revenue effect at all, this particular proposition.

The last point I would raise—and again in anticipation of questions that might come—well, why not have, if you have a company that has discounted these reserves, that was an advantage to them, a competitive advantage to them. It would only be fair it would seem to have something less advantageous to those who have been discounting over the years as opposed to those who have not. And certainly that is a fair question, considering that they were doing business differently.

A couple of point I think would help, just looking at the history of the companies. The ones who have been discounting the reserves indicate that the capacity to write insurance was not improved due to the extra surplus resulting from discounting.

A common measure of a company's capacity to write business is the ratio of written premiums to surplus, the surplus ratio, as it is called. With or without reserve discounting, the companies have maintained a surplus ratio at levels comparable to those of its major competitors and its capacity to write business has not been constrained by the National Association of Insurance Commissioners' surplus ratio limit benchmark of 3 to 1.

And, lastly, another mark would be to look at the competitive factors in a major Connecticut company that would be affected by this change, I would say to the chairman, shows that in fact the market share has fallen from 4.12 percent in 1971 to 2.94 percent in 1986. So had the discount reserves been a significant competitive advantage, I think the market share would be reflected differently in those numbers. And I would offer that as some evidence that it would not place them in a, or has placed them, rather, in a competitively advantaged situation.

At any rate, Mr. Chairman, that is the sum and substance of it. I will be glad to submit the documentation on this to make the case, but I appreciate the opportunity to be before you and explain this proposal.

Senator BAUCUS. Thank you, Senator Dodd.

Apparently this is still some difference as to the revenue effect which has to be worked out.

Senator DODD. Yes, there is. I understand that.

Senator BAUCUS. And I, with Secretary Chapoton, have discussed accounting rules. If there is some way we can work out some accommodation in revenue, that I would think would help this committee significantly. But I appreciate your appearance and your testimony. Thank you very much.

Senator DODD. Thank you very much.

Senator BAUCUS. Our next panel is Mr. Larry White, who is a member of the Board of the Federal Home Loan Bank Board. Mr. White, why don't you proceed. We are happy to have you here.

[The prepared written statement of Senator Dodd follows:]

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify before you this morning. My appearance before the Committee today is to highlight my concern about a substantial inequity in the Tax Reform Act of 1986 ("1986 Act") that I believe should be corrected through an amendment to S. 1350. This inequity arises from the transition rules regarding the implementation of new discounting rules applicable to property and casualty insurance companies. These rules are referred to as the "fresh start rules."

The 1986 Act's fresh start rules treat otherwise identically situated property and casualty insurance companies differently, depending on whether or not a company previously discounted loss reserves as now mandated for everyone. Quite unfairly, a company that previously discounted reserves is disadvantaged by the fresh start rules in comparison to the company which is only now beginning to discount. Specifically, if two property/casualty insurers have identical reserve liabilities, but one previously discounted loss reserves on its annual statement and the other did not, the company that has been discounting will receive a substantially smaller fresh start than its competitor. The competitive concerns associated with this inequitable treatment are apparent. Attached to my statement is an illustration of the inequity and statutory language that would address it (Attachment A).

I believe that it is appropriate to address this problem in the technical corrections bill. The change that I am asking you to consider is not a new transition rule. It is an amendment to a transition rule contained in the '86 Act.

I am of course aware that revenue concerns represent a major factor in assessing technical corrections legislation. While I believe that the fairness aspects of this matter independently justify addressing the matter in S. 1350 without regard to revenue considerations, I also believe that the proposed amendment properly should be treated as having no revenue effect. The proposed amendment would conform the statute to the method of estimating the cost of the fresh start benefit at the time of the enactment of the 1986 Act. Attached to my statement is a memorandum which discusses this point in more detail (Attachment B).

I am informed that the analysis of the revenue cost of the proposed amendment set forth in the attached memorandum is consistent with the approach the Joint Committee on Taxation took in estimating a conceptually comparable provision included in S. 1350. Specifically, section 105 (a) (10) of S. 1350 indicates that post-1986 installment sales income attributable to pre-1987 sales of passive loss type activities will be treated as passive income for purposes of offsetting passive losses under section 469 of the IRC. This provision of S. 1350 specifically reverses the published position of the Internal Revenue Service on this matter. It is my understanding that the Joint Committee on Taxation has taken the position that section 105 (a) (10) of S. 1350 has no revenue effect because the change will conform the statute to the assumption under which the Joint Committee on Taxation originally estimated the revenue effect of the passive loss rules. I believe this situation is conceptually identical to the situation concerning the proposed amendment because the amendment would conform the statute to the assumptions under which the Joint Committee on Taxation originally estimated the revenue effect of the fresh start rules.

I very much appreciate the attention of the Committee to this important matter.

ATTACHMENT A

TAX REFORM ACT OF 1986
PROPERTY AND CASUALTY INSURANCE RESERVES:
FRESH START TRANSITIONAL RULES

Tax Reform Act of 1986 -- Sec. 1023. Section 1023 of the Act (section 846 of the Code), relating to the taxation of property and casualty insurance companies, requires these companies to discount their loss reserves for the first time. As a part of this provision, section 1023 (e) (3) provided a so-called "fresh start" rule. The purpose of the "fresh start" rule was to allow insurers to start the year 1987 on the new, discounted basis for their loss reserves without taking into account any differences between the old and new bases for purposes of determining their taxable income.

Problem. This fresh start rule determines the new base by applying the new tax reserve discount factor to the "undiscounted annual statement reserve."

Thus, this rule provides a different amount of "fresh start" depending solely upon whether or not a company has been discounting its reserves on its annual statement. In other words, two insurance companies with identical liabilities will receive a different fresh start benefit if one company has been discounting such reserves on its annual statement ("A/S"), and the other company has not. The company that has been discounting such reserves will receive a smaller fresh start amount than the other company. This result is inequitable.

Solution. This inequity could be substantially corrected by applying the tax reserve discount rate to the "annual statement reserve (line 2 below) rather than the "undiscounted annual statement reserve" (line 1 below). This approach would result in substantial equity between Company A and Company B.

Illustration.

		Company A	Company B
1.	Undiscounted A/S Reserve	100	100
2.	A/S Reserve	100	95 (disc.)
3.	Fresh Start Rule:		
	Old Basis (line 2)	100	95
	New Basis (line 1) x (.93, assumed tax discount rate)	93	93
	Fresh Start Amount	7	2
4.	Proposed Fresh Start Rule:		
	Old Basis (line 2)	100	95
	New Basis (line 2 x .93)	93	88.35
	Fresh Start Amount	7	6.65

Statutory Draft

This proposed fresh start transition rule might be implemented by amending section 1023 of the Tax Reform Act of 1986 as follows:

SEC. ____ . AMENDMENT RELATED TO SECTION 1023 OF THE ACT.

Paragraph (2) of section 1023 (e) of the Tax Reform Act of 1986 (relating to transition rules) is amended by adding at the end thereof the following new sentence:

"For purposes of the first sentence of this paragraph, unpaid losses with respect to workers' compensation shall be determined without application of paragraph (2) of section 846 (b) of such Code (as added by this section) where such unpaid losses were shown on the annual statement on a discounted basis."

ATTACHMENT B

M E M O R A N D U M

ANALYSIS OF PROPER ESTIMATING CONVENTION FOR TRANSITION RULE INTENDED TO CONFORM FRESH START BENEFIT FOR PRE-1986 DISCOUNTED RESERVES

I. Background

The Tax Reform Act of 1986 ("1986 Act") for the first time requires property and casualty insurance companies to discount unpaid losses and certain unpaid expenses. Section 1023 of the 1986 Act and section 846 of the IRC. This provision is generally applicable to taxable years after December 31, 1986. Section 1023(e)(1). Application of the discounting provisions to existing reserves is governed by section 1023(e)(2). It provides that opening reserves on January 1, 1987, are to be calculated as if the discounting provisions of the 1986 Act originally had been applicable to the losses and expenses related to these reserves. The provision is similar to a comparable provision provided in the Deficit Reduction Act of 1984 related to a modification of the reserve deductions allowed for life insurance companies. The effect of this provision is to provide a double deduction of the amount equal to the difference between undiscounted expenses and losses and the discounted expenses and losses (the "fresh start benefit"). Under section 1023(e)(3), the fresh start benefit is not to be taken into account for purposes of the Internal Revenue Code of 1986. The fresh start benefit for a property and casualty insurance company generally is equal to the difference between the undiscounted reserves and the discounted reserves. For example, if a company had an undiscounted reserve of $100 on December 31, 1986, effective January 1, 1987, such reserve would be restated as if it had been discounted originally, i.e., at $93. In this case, the amount of the fresh start benefit is $7.

Prior to the 1986 Act, almost all property and casualty companies did not discount unpaid losses or unpaid expenses. A small minority of companies already had begun discounting of such reserves prior to the 1986 Act. For those companies, the application of the fresh start rules will provide a smaller benefit than for those companies that had not been discounting reserves. For example, if in the example discussed above the company had discounted its $100 reserve to $95 prior to the 1986 Act, the amount of the fresh start benefit would only be $2 (i.e., the difference between $93 and $95).

II. Proposed Conforming Transition Rule

The operation of the fresh start rule under section 1023(e) unfairly discriminates in favor of those companies that had not discounted reserves prior to the 1986 Act while penalizing companies that already had been discounting reserves. It is suggested that a proper method of addressing this discriminatory aspect is to provide a conforming transition rule which would provide companies that had been discounting reserves prior to the 1986 Act with treatment comparable to that of companies that had not discounted reserves.

III. Proper Estimating Convention for Transition Rule to Conform Fresh Start Benefit.

A. Overview.

In considering the proposed transition rule, a relevant factor will be, what, if any revenue effect should be attributable to it. The purpose of this memo is to suggest that the transition rule proposed should be treated as having no revenue effect. There are two possible ways in which the fresh start benefit originally could have been estimated. Under either approach, it is believed that the inclusion of the proposed transition rule would not have affected the revenue estimate and, therefore, should be treated as having no revenue effect if implemented as part of technical correction legislation. The two possible methods of originally estimating the fresh start provision are discussed below along with the basis for concluding that the proposed transition rule should be viewed as having no revenue effect as part of technical corrections legislation.

B. Estimate of Transition Rule Assuming that the Fresh Start Benefit was not Originally Taken Into Account in Computing Discounting Provisions.

It is possible that the estimate of the discounting provisions of the 1986 Act did not take into account the fresh start aspect of these rules. No publicly released documents indicate that the fresh start benefit was taken into account. If this is the case, the inclusion of the proposed technical correction transition rule would have had no impact on the estimate of the impact of the discounting provisions nor would it have had an impact on the overall estimate of the provisions affecting the property and casualty industry. If this is the case, inclusion of the technical correction transition rule as part of the technical corrections process also should be viewed as having no revenue effect.

C. <u>Effect of Proposed Transition Rule Assuming that the Fresh Start Provisions were Taken into Account in Estimating the Discounting Provision</u>.

In the alternative, the method used to estimate the discounting provisions may have assumed some loss of revenue attributable to the fresh start benefit. Given the small minority of companies which were actually discounting reserves prior to the 1986 Act, however, it is unlikely that any assumption was made as to the effect which the discounting of those reserves prior to the 1986 Act had on the effect of the fresh start benefit. That is, it is assumed that the fresh start benefit was calculated assuming that no companies were discounting reserves prior to the 1986 Act. As a consequence, the inclusion of the proposed technical transition rule to provide all companies with the same fresh start benefit without regard to whether they were discounting reserves prior to the 1986 Act would have had no impact on the validity of the initial revenue estimate. As a result, the inclusion of the proposed technical transition rule as part of the technical corrections legislation also should be viewed as having no revenue impact.

STATEMENT OF LAWRENCE J. WHITE, BOARD MEMBER, FEDERAL HOME LOAN BANK BOARD, WASHINGTON, DC

Mr. WHITE. Thank you, Mr. Chairman. I want to thank you for the opportunity to testify this morning. I have provided a longer statement and a summary that I would like to have entered into the record.

Senator BAUCUS. It will be included.

Mr. WHITE. I will try to be brief.

My name is Lawrence White. I am a Board Member of the Federal Home Loan Bank Board. We are also the Federal Savings and Loan Insurance Corporation, the government agency that regulates the thrift industry and protects depositors and thrift institutions.

As you know, the FSLIC is currently insolvent. We hope to receive recapitalization authority from the Congress soon, but even then our resources will be inadequate. Consequently, all efforts to conserve the FSLIC's scarce resources to permit our scarce dollars to go farther are vital to us.

The three technical amendments to the 1986 Tax Reform Act that we urge you to add to S. 1350 would have that effect, and they would be consistent with the recapitalization legislation.

We believe that these truly are technical amendments. They do not represent new policy or a change in policy. They are simply correcting inadvertent and unintended glitches in the 1986 Tax Reform Act, which are inconsistent with the broader policy positions of the Congress in that Act. And the changes we propose do represent sound public policy.

The first item concerns the 20 percent deposit continuity test for preserving tax loss carry forwards in supervisory mergers. Under prior law, there was a scaling down or a "slope" in the use of tax loss carry forwards if an acquired institution was less than 20 percent of the resulting entity. The 1986 Tax Reform Act changed this slope to a "cliff" at 20 percent, with greatly reduced use of tax loss carry forwards.

Mergers involving troubled thrifts were inadvertently included in the application of this cliff. I say "inadvertent" because it was the intent of the Congress in the Tax Reform Act to preserve special tax treatment for FSLIC supervised acquisitions involving troubled thrifts until the end of 1988.

Further, we have safety and soundness concerns that cause us to favor relatively large institutions' acquiring smaller troubled ones because a larger institution is better able to absorb the problems that frequently appear on the balance sheet of a troubled thrift. But the 20 percent cliff makes it harder and more costly for us to find larger acquirers.

Let me add that through hard bargaining we are able to capture for the FSLIC, through a lower payment to the acquirer, the tax benefit that would appear initially to benefit the acquirer. So the FSLIC would be the real beneficiary of this change.

This cliff has real world consequences. I have seen mergers delayed, and acquirers try to shrink in the week or two before an acquisition, just to get past the 20 percent cliff. Tax law glitches that cause this kind of artificial effort cannot represent good public policy.

Our second item involves the provision in the 1986 Tax Reform Act that states that two reorganizations within two years cause the tax loss carry forwards of a company to be lost entirely at the time of the second reorganization.

Now, frequently when a thrift is out of control or is losing money and has management that is hostile to the Bank Board's regulatory concerns, we need to put the thrift into an interim holding pattern so that we can stabilize it. In this way we can get a better picture of the assets and liabilities of the thrift and thereby do a better job of marketing the institution, with the ultimate result of saving money for the FSLIC.

To achieve this holding pattern, we put the troubled thrift into a pass through receivership. We create a new institution with a new set of managers that are answerable to us. Eventually, we hope to find a new set of owners for the thrift.

We are concerned that this first step, the pass through receivership, might be considered to be the first of two reorganizations, thus implying that the subsequent transfer of the thrift to new owners would cause the tax loss carry forwards to be extinguished and thus again raising the cost to the FSLIC of finding acquirers for these thrifts. We believe that this cannot have been the intent of Congress.

We currently have 49 thrifts with $23 billion in assets that have already gone through this first step. Unfortunately, we will have to use this process for many more in the future. Consequently, this is an important provision.

Third, the FSLIC has a strong policy interest in encouraging the conversion of mutual institutions to stock institutions through public offerings. These conversions bring added capital to the industry. They provide the thrifts with added net worth, which provides greater protection to the FSLIC insurance fund.

In recognition of this public interest in encouraging conversions, the Congress in the 1986 Tax Reform Act allowed the tax loss carry forwards to be preserved for conversions through the end of 1988. For "plain vanilla" conversions, there seems to be no problems, but for other forms of conversions, there may be restricted use of the tax loss carry forwards.

These are just mechanical, alternative ways of achieving the desired conversions. The form of the conversion should not matter. Congress' intent should be preserved.

So, in all three areas we believe that the corrections are technical. They represent the reestablishment of the Congress' primary intentions, and they represent sound public policy.

Mr. Chairman, I will be happy to answer any questions.

Senator BAUCUS. Thank you, Mr. White.

Essentially these are changes to help the Board facilitate reorganizations?

Mr. WHITE. That is correct. And ultimately they do benefit the Federal Savings and Loan Insurance Corporation.

Senator BAUCUS. Is there any revenue effect?

Mr. WHITE. Excuse me.

Senator BAUCUS. Is there any revenue effect?

Mr. WHITE. Well we have not been able to calculate the exact revenue effect of just these three small changes. The 1986 Tax

Reform Act had an estimate of the revenue effects of the entire range of the special provisions for FSLIC-related transactions. Those were $46 million in 1989; $105 million in 1990.

Senator BAUCUS. But for these——

Mr. WHITE. And this is just a small——

Senator BAUCUS. It is comparatively insignificant?

Mr. WHITE. Well they are certainly very small, as compared with those larger numbers that involve the full range of provisions.

Senator BAUCUS. Thank you.

Mr. WHITE. Thank you very much, Mr. Chairman.

Senator BAUCUS. Our next panel will consist of Ambassador Veliotes, President of the Association of American Publishers, Washington, DC; Mr. Robert K. Massie, President of the Authors Guild, Inc., Irvington, NY; Mr. David Silver, President, Investment Company Institute, Washington, DC; Mr. Herbert J. Lerner, Chairman, Tax Division, American Institute of Certified Public Accountants, Washington, DC; and Mr. David Kasten, 12th District Farm Credit Board Director, testifying on behalf of The Farm Credit Council, Brockway, MT; accompanied by Mr. Malcolm Harding, President, Central Bank for Cooperatives, testifying on behalf of the Farm Credit System, Denver, CO.

Before we begin this panel I would like to remind everyone that their written statements on proposed technical corrections will be received by this committee through Friday, July 24th. So anyone who wishes to comment can do so and the written comments will be included in the record.

We have quite a few witnesses here, so I am going to ask the witnesses to conform, and to constrict and constrain themselves to three minutes. And as I said, written comments will be received by this committee by the 24th of this month and they will be included in the record.

The first witness is Ambassador Veliotes.

[The prepared written statement of Mr. White follows:]

STATEMENT OF

LAWRENCE J. WHITE

BOARD MEMBER

FEDERAL HOME LOAN BANK BOARD

Mr. Chairman, Members of the Subcommittee:

I am pleased to be here this morning, and I thank you for the opportunity to present the comments of the Federal Home Loan Bank Board ("Bank Board") and the Federal Savings and Loan Insurance Corporation ("FSLIC") regarding S.1350, The Technical Corrections Act of 1987. We are proposing three technical corrections to new Code section 382 (relating to limitations on net operating loss carryovers and other tax attributes following a corporate reorganization) as enacted by the Tax Reform Act of 1986. Our proposals supplement the helpful corrections already included in S. 1350, as introduced.

In the Tax Reform Act of 1986 ("1986 Act"), Congress decided to continue the entire group of tax provisions dealing specifically with FSLIC transactions but to subject them to review at the end of 1988. The 1986 Act thus "sunsets" the FSLIC provisions at the end of 1988, thereby enabling Congress to review the continued need for the provisions beyond that period. However, we have identified three items that we believe are wholly technical in nature. They contain no hidden effects or changes for FSLIC transactions, and we believe that they pose no problem with respect to the harmonization of the treatment of those items alongside the unaffected provisions of the 1986 Act.

1. <u>20% deposit continuity test for NOL carryovers.</u>

Under prior law, in a supervisory merger of a failed thrift, net operating loss (NOL) carryovers were fully preserved if the acquired thrift's deposits comprised at least one-fifth (20%) of the combined deposits of the combined institution after the merger. If this level was not attained, the carryovers were "scaled down" by 5% for each 1 percentage point below 20% represented by the transferred deposits. (Former sec. 382 (b)(7)(B)). This provision treated thrift deposits as stock for purposes of qualifying under the general rule of prior sec. 382(b). That general rule, applying to all reorganizations, preserved the full dollar amount of NOL carryovers if "shareholders" of the loss company received stock worth 20% or more of the value of all the stock of the combined company. If the 20% level was not attained, the scaledown formula applied, that is, the carryover dollar amount was reduced by 5% for each 1 percentage point below the 20% level.

In the Tax Reform Act of 1986, Congress decided to continue, at least through the end of 1988, the prior law relating to FSLIC-supervised acquisitions. This policy meant preserving the special qualifying reorganization rules in sec. 368(a)(3)(D)(ii), the tax attribute rules of sec. 382, and the treatment of FSLIC assistance payments in sec. 597. Neither the Conference Report nor the "Bluebook" prepared by the staff of the Joint Committee on Taxation expresses any intent to alter the FSLIC tax provisions in any substantive way.

The statute itself, however, does not contain the graduated scaledown of tax attributes where the 20% deposit proportion is not attained in a FSLIC-supervised acquisition. As a result, the NOL carryovers would be severely limited in those cases after the merger. The annual limitation on utilizing the defaulted thrift's tax attributes would come into play, creating a large "cliff" depending on whether the 20% proportion is met or missed, even barely. This inadvertent omission in the statute creates undesirable difficulties for the Bank Board and the FSLIC. On one hand, it tends to discourage the very type of acquisition which FSLIC encourages, namely, very large acquirers agreeing to rescue smaller institutions. Larger acquirers offer better prospects of rehabilitating a troubled institution. On the other hand, if the tax rules compel the FSLIC to locate acquirers that are not so big as to trigger the "cliff" -- because the 20% deposit ratio will not be attained -- the Bank Board has regulatory concerns over the safety and soundness of the acquisition. The tax rules should not place the federal regulator in such a difficult position.

In a sample of eleven FSLIC-assisted mergers completed in 1986 and 1987, six of the mergers did not meet the 20% ratio. If these six mergers were subject to the statute as it now reads, the NOL carryovers would be lost as a result of the "cliff," and FSLIC would not receive any related benefit. Furthermore, in one of the five mergers that did meet the 20% ratio the asset mix was intentionally rearranged in order to preserve $200 million in NOL carryovers. In addition, a primary reason a pending merger has been delayed is to consider ways to rearrange the deposit ratio in an attempt to preserve $110 million in NOL carryovers.

The scaledown rule of prior law was not ambiguous or difficult to apply. It was part of the prior tax rules that applied to assisted thrift mergers and should be restored to current law, as Congress intended.

2. Possible complete extinguishment of NOL carryovers where FSLIC creates an "interim" association.

Under the 1986 Act, a second reorganization occurring within two years after a first reorganization extinguishes NOL carryovers in toto for the years following the second reorganization (sec. 382(l)(5)(D)).

This provision could totally eliminate NOL carryovers in a FSLIC-supervised acquisition of an insolvent thrift where the thrift's assets are first conveyed to an "interim" savings and loan association created and operated by the FSLIC while a buyer is sought, and then a buyer acquires control of the interim association. In private tax rulings IRS has treated these steps under prior law as two successive type (G) reorganizations. See PLR 8411060 (Dec. 14, 1983). This two-step format would not have had any adverse effect on NOL carryovers under prior law, because no penalty arose based on a short time period between successive reorganizations.

The two-step format in FSLIC transactions where an interim thrift association is created is not part of any arrangement involving potential abuse. The two-year rule in new sec. 382

appears to have been developed in order to prevent creditors of a bankrupt regular corporation from becoming shareholders of the corporation, preserving NOL carryovers for their ultimate benefit, but thereafter selling off their stock to third parties who are strangers to the company and whose money did not finance the operating losses. FSLIC transactions are altogether different. An interim thrift association is created by the FSLIC in receivership situations where it is essential to protect depositors in the defaulted institution and quickly remove assets and liabilities to a more secure corporate entity. To achieve this objective, if an ultimate buyer for the institution has not been located at the time the failed thrift is placed in receivership, the FSLIC may create a newly chartered Federal mutual savings and loan association to receive assets and deposit liabilities, and to operate thereafter with new management, until an ultimate purchaser can be found. The selection of a purchaser may itself involve a period of time consisting of an invitation for proposals from interested potential purchasers and, after acceptance of a particular proposal, negotiation of an assistance agreement with the FSLIC. In substance, the creation of the interim mutual association is a holding action, and the purchaser's acquisition of the interim association is the true acquisition.

Therefore, the Board believes that the two-year provision of new section 832(l)(5)(D) was not intended to apply to, and ought not apply to, a FSLIC-supervised acquisition that may involve a "holding" entity. Such a two-year rule was not a part of prior law and should not now be imposed as a new obstacle in view of Congress' policy to continue the prior law as it applied to FSLIC transactions.

In accord with Congress' policy to maintain prior law through 1988, the two parts of a supervisory acquisition should not cause any loss of tax attributes.

3. Public offerings of stock in a thrift converting from mutual to stock form.

Sec. 621(F)(4) of the Tax Reform Act of 1986 effectively prevents the new limitations on NOL carryovers from applying to public offerings of stock in a savings and loan association that is converting from mutual to stock form during 1987 and 1988. The transition rule exempts from the definition of an equity structure shift in new sec. 382 a public offering "with respect to domestic building and loan transactions * * *." This "window" clearly applies to a mutual thrift issuing its stock directly to the public.

Three other mechanical ways to convert a thrift from mutual stock form should also be covered under the special two-year "window":

(1) A "merger conversion," where a mutual S&L or savings bank merges into a newly-created or existing S&L, and a public offering is made of stock in the acquiring association;

(2) A "holding company conversion," where a holding company purchases all the conversion stock and makes a public offering of stock of the holding company; and

(3) A "holding company conversion" where the mutual merges into a newly-created or existing S&L that is a subsidiary of a savings and loan holding company, and the public offering is made of <u>stock of the holding company</u> (rather than of the subsidiary itself).

The IRS has issued numerous private letter rulings approving all three types of conversions as taxfree reorganizations. However, under the new NOL carryover restrictions the first and third formats would technically be classified as equity structure shifts, which in turn will cause NOL carryovers to be limited under the new general rule, i.e.

only a small percentage of the NOL carryover can be utilized each year.1/ It is unclear, as the Board reads the language of Section 621(f)(4) of the Tax Reform Act, whether the phrase "domestic building and loan transactions" extends to a conversion by merger with a different corporate entity and a public offering of stock in the acquiring entity or in a holding company which is the parent of the acquiring entity.

If a holding company buys the conversion stock and then sells stock in the holding company (Situation (2)), it is also unclear whether the public offering is a "domestic building and loan transaction" within the meaning of the two-year window.

The mechanical form of accomplishing a mutual-to-stock conversion should not be significant. Allowing form to prevail over substance will inhibit the FSLIC's capital-raising goal to

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1/ The general rule of sec. 382 would govern because, under the rules, investors in the public offering would be viewed as causing a greater-than-50% change in the ownership of the converting mutual association. This result would occur pursuant to new sec. 382(g) (4) (B) (i), which in the case of a merger involving two distinct corporations, segregates the shareholders of each separate company in calculating whether an ownership change has occurred.

forestall defaults and attract private capital into the thrift industry. The conversion formats described above should be equally protected under the two-year exemption in Sec. 621(f)(4) of the Tax Reform Act for thrift conversions during 1987 and 1988.

A revision of the language of Sec. 621(f)(4) of the Tax Reform Act, as proposed in H.R. 2636, also seems uncertain with respect to covering the conversion mechanics described above. The bill (sec. 106(d)(15)) would substitute a reference to "institutions described in section 591 of such Code with respect to any public offering before January 1, 1989." This language seems literally inapplicable to a public offering of stock in a holding company that is not itself a thrift institution. The language is also ambiguous with regard to whether it refers only to a public offering of stock in the mutual entity itself, or also to a public offering of stock in an entity which acquires assets of the converting institution by means of a statutory merger.

The Board and the FSLIC welcome the three items referred to below that are already included in S. 1350, as introduced.

First, for purposes of the survival of NOL carryovers, the 20% deposit proportion test will be calculated solely by reference to the value of the deposits and not by requiring savings deposits to possess voting power. Section 106(d)(8)(A), Technical Corrections bill.

Second, a firm commitment underwriting in connection with a public offering of stock in a converting mutual savings and loan association is protected against reduction in NOL carryovers under the two-year "window" for thrift public offerings during 1987-88. Sec. 106(d)(15), Technical Corrections Bill.

Third, savings banks, in addition to savings and loan associations, are included in the two-year "window" for NOL carryovers in thrift public offerings during 1987-88. Sec. 106(d)(15), Technical Corrections Bill.

STATEMENT OF AMBASSADOR NICHOLAS A. VELIOTES, PRESIDENT, THE ASSOCIATION OF AMERICAN PUBLISHERS, WASHINGTON, DC, ACCOMPANIED BY MORTIMER CAPLIN, COUNSEL, CAPLIN & DRYSDALE

Ambassador VELIOTES. I am Nicholas Veliotes, President of the Association of American Publishers, and our members publish almost three-quarters of the books sold in this country. With me is AAP's counsel, Mortimer Caplin, of Caplin and Drysdale.

We very much appreciate the opportunity of testifying on an imminent and urgent problem faced by our industry today. We have already submitted a detailed statement for the record. Today, I would like to focus on the basics of our position.

Mr. Chairman, we strongly believe that the Technical Corrections Act should amend section 174 to make it clear that the publishers of instructional and educational materials are eligible to deduct research and development costs. First, on grounds of fairness. Unlike any other taxpayer, the book publishers will not be allowed to deduct otherwise eligible R&D expenses under article 174. This is discriminatory; it serves no public purpose.

The problem arises from a last minute footnote inserted in the Conference Report which, in essence, has been interpreted by the Treasury has given them no choice but to disallow the R&D deduction for book publishers.

Treasury has spelled this out in their recently issued regulations. But given the long history of this issue, and Congress' allowability of these deductions in section 2119 of the 1986 Revenue Act, we do not believe Congress intended this result.

Let me stress that we are not asking for special treatment, but only equal treatment with other industries.

Second, to serve the cause of quality education, we seek eligibility under section 174 for publishers of educational instructional materials and professional and reference books. We all recognize the importance of quality education in the United States. This is an item on the top of everyone's agenda, as made clear again in the Trade bill approved by the Senate last night. We believe the Congress as a matter of broad public policy should treat the publishers of educational materials fairly under the tax laws, and thus encourage them to continue to invest the heavy resources required for the development of quality instructional programs and materials.

Third, research and development. And, finally, Mr. Chairman, I wish to emphasize that we do engage in real research and experimentation in the development of these materials. This subject is addressed in detail in my written statement.

All the elements of hard R&D exist. For example, understanding how children learn, how teachers teach, and to find out the most effective ways of bringing excellence into the classroom. In fact, with textbooks, the classroom is our laboratory.

Thank you, Mr. Chairman.

Senator BAUCUS. Mr. Ambassador, you are to be commended. You completed in three minutes. Thank you very much.

Mr. Massie.

[The prepared written statement of Ambassador Veliotes follows:]

Statement by

NICHOLAS A. VELIOTES
Association of American Publishers, Inc.
Washington, D.C.

HEARINGS BEFORE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

Room SD-215, Dirksen Senate Office Building
9:30 a.m., Wednesday, July 22, 1987

My name is Nicholas A. Veliotes, and I am President of the Association of American Publishers ("AAP"), the major national association of book publishers whose members publish about 70% of the books sold in the United States. I am accompanied by AAP's counsel, Mortimer Caplin, of the Washington law firm of Caplin & Drysdale.

Let me first summarize the views of the AAP on an issue of vital importance to the book publishing industry of this country:

1. New section 263A contains an ambiguity that the Treasury interprets as denying book publishers a section 174 deduction for its prepublication "research or experimental" expenses ("R&D") in developing instructional, reference and professional materials. <u>The TCA should amend section 174 to make it clear that book publishers, like other American businesses, are eligible to deduct these R&D costs</u>.

2. The activity of book publishers in creating new instructional, reference, and professional works, involves efforts that, by their nature, clearly constitute R&D and that, for any other industry, would qualify for deduction under section 174. However, Treasury Regulations § 1.174-2(a)(1)--for some vague and unexplained reason--generally denies section 174 deductions for expenditures for "research in connection with literary, historical, or similar projects." And the Internal Revenue Service, in Revenue Ruling 73-395 (1973-2 C.B. 87), specifically rejected the book publishers' plea for equal treatment when it pronounced that "costs incurred in the writing, editing, design and art work directly attributable to the development of the textbooks and visual aids do not constitute research and experimental expenditures under Section 174."

3. In 1976 Congress enacted legislation (section 2119 of the 1976 Tax Reform Act) that blocked the IRS' efforts to deny these deductions. The effect of the 1976 legislation has been to

allow book publishers to deduct, as current expenses, their editorial and similar costs incurred in the process of developing new books, thereby maintaining equality with other industries.

4. Based on a footnote in the 1986 Conference Report, the Treasury now takes the position that the 1986 Act, by implication, repealed the 1976 protective statute (section 2119). It further insists that costs of developing printed materials are automatically excluded from section 174 treatment, regardless of the character of the materials or the development process involved.

5. Treasury's interpretation of section 263A singles out and discriminates against the book publishing industry. For virtually all other industries, costs of developing new products can still be deducted currently as R&D costs under section 174. Book publishers, practically alone, would be denied these current deductions.

6. AAP submits that Treasury's position (embodied in its temporary and proposed regulations) is inconsistent with the terms of both the 1986 Act and the 1976 legislation, as well as grossly unfair and contrary to sensible national policies and priorities.

7. AAP requests that the TCA include a provision clarifying that book publishers' R&D costs for instructional, reference, and professional materials are eligible for treatment as R&D costs under section 174. The clarification would apply only to these limited classes of publications. Further, it would be confined only to costs that clearly constitute R&D. Not within the purview of section 174, but instead subject to capitalization, would be the following: Advance royalty payments to authors and costs of actual manufacture of the books or other products, including platemaking costs (material, typesetting, film making and labor), as well as production costs (paper, ink, binding, jackets and labor).

R&D EXPENDITURES BY PUBLISHERS

The activities of a book publisher in preparing instructional, reference, or professional materials involve work that qualifies as "research or experimental" ("R&D") by any reasonable standard. We have submitted, for the information of the Committee, a detailed description of how a book publisher develops an elementary textbook system. Publishers of materials for use at other educational levels, as standard reference works, or for home-study or professional development follow similar procedures.

In general, the process begins with careful research into the need for a new or improved product, followed by preliminary testing and definition of pedagogical and substantive approaches and concepts. This phase features extensive review of the latest pedagogical data and analysis, as well as interacting with teachers, academics and school administrators. Thereafter, the publisher's staff, in collaboration with the author or team of authors selected to carry out the project, defines the general specifications for the product. Based on these specifications, the publisher and author team work together to create one or more prototypes of the new product.

These prototypes are then tested and evaluated by the publisher's staff, working in classroom settings with teachers and students and with experts in the field, to develop highly detailed specifications. These specifications function as blueprints for the authorship team in preparing the first full manuscript. The authors then prepare successive drafts, which are reviewed by the publisher's staff for conformity to the specifications, and subjected to further field testing and evaluations.

Throughout the process, the publisher is continually and closely involved in classroom testing and in expert evaluation to determine if the product will function properly in the intended educational setting. Based on this trial-and-error approach, the product is modified until a final version is ready to be prepared for printing and mass production. In some cases, particularly in the case of elementary and secondary school textbooks subject to a governmentally operated "adoption" procedure, the process of testing and modification continues even after the materials are initially prepared for printing and manufacture.

The process of developing instructional, reference, and professional material is characterized by heavy involvement of the publisher's staff, not merely in revising an author-submitted manuscript, but in conceptualizing the product, developing detailed plans, and working with potential users and substantive and instructional experts in testing and evaluating preliminary outlines and drafts. In response to these tests and evaluations, the product under development is continually modified and adjusted as the development process goes on.

In all instances, this preproduction development process for instructional, reference, and professional materials is not what is normally thought of as "editing." It is a radically more complex, sophisticated and intense process. It considers not only the order and organization of the words used, but the whole format for presenting the material, including the scope of the subject covered, the order of presenting subjects, the relation of graphics and illustrations to the educational objectives of the publication, and the effectiveness of particular methods of presenting the material. It embodies classroom field tests and expert evaluations of preliminary designs and prototypes that feed back into the process.

In many cases, the product resulting from these R&D efforts comprises several interrelated elements to be used in conjunction with each other. For example, in the case of elementary school instructional materials, the product developed by this process of research, experimentation and testing, with modifications based on results at earlier stages, is not a single textbook, but a whole system of teaching aids (such as filmstrips, overhead transparencies, demonstration materials, and computer software), teacher manuals and special teacher editions of the text, student workbooks, and testing materials.

The instructional publisher's systematic planning, testing, and evaluation throughout a product development process, feeding back into continual modifications of the emerging product to insure effective application of knowledge and techniques to a final product, is exactly analogous to the R&D process of other industries which apply technology and the results of experimentation to the development of new products.

There is no sound reason to deny publishers of instructional, reference, and professional materials the same tax treatment for R&D costs that manufacturers of other products enjoy. Indeed, the critical social importance of quality educational materials makes it especially appropriate to allow current deduction treatment in these cases.

LEGISLATIVE AND REGULATORY BACKGROUND

Since 1954--and, in practice, before that--costs of research and development of new products have generally been allowed as a current deduction under section 174, even if those costs would otherwise have to be capitalized. In 1986, Congress adhered to the consistent practice of favoring new product development by creating a major statutory exception to the new uniform capitalization rule--section 263A(c)(2), which specifically preserves the section 174 deduction for "research or experimental" expenditures ("R&D"). Consequently, most industries will gain significant relief by being able to continue to deduct costs of product R&D.

Barred from this relief, however, is the book publishing industry, which has been disqualified from using section 174 by the Treasury's erroneous reading of section 263A. As a result, book publishers will be subject to the full rigor of section 263A, even for R&D devoted to the creation of "intangible" assets in the form of copyrights--despite the fact that section 263A specifically applies to real property and only "tangible" personal property.

Treasury Regulations § 1.174-2(a)(1)

Section 174 was included in the 1954 Act as originally enacted to--in the words of the reports in both Houses of Congress--"encourage taxpayers to carry on research and experimentation." H.R. Rep. No. 1337, 83d Cong. 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong. 2d Sess. 33 (1954). Section 174 does not discriminate among different kinds of products, and there was no discussion of any such limitation when it was enacted.

At the outset, the regulations under section 174 interpret its scope very broadly to include "all ... costs incident to the development of ... a product." Treas. Reg. § 1.174-2(a)(1). In practice, the cases, published revenue rulings, and internal IRS pronouncements reflect this broad view and permit almost all industries to elect under section 174 to deduct their product development costs. In many cases, neither the products nor the process have the high degree of technical content manifested in the development of instructional, reference, and professional publications.

Treasury has, however, resisted application of section 174 deductions to <u>any</u> printed product, regardless of its character. Reg. § 1.174-2(a)(1) (originally adopted in 1957) has provided that "research or experimental expenditures" do not include "expenditures paid or incurred for research in connection with literary, historical, or similar projects." Although this could reasonably be read only as preventing amateur writers from attempting to deduct the costs of their "research hobbies," Treasury has read it as barring R&D treatment for any product embodied in print, even highly technical material or material developed on the basis of a process of analysis and experimentation that would clearly qualify as R&D in any other context.

The discrimination against book publishers is put into sharp focus when one recalls that in 1983 Treasury spokesmen recognized that R&D deductions are claimed by taxpayers in such varying business lines as fast food restaurants, baked goods, home building, banking, stock brokerage and the like. Even more startling, computer software products--commonly produced by book publishers, and marketed and inventoried side-by-side with books containing identical information--are given generous R&D deduction treatment by the IRS. It is anomalous to permit R&D deductions for one type of intellectual product while denying it to another similar product.[1]

<u>Revenue Ruling 73-395 and Congressional Criticism</u>

Prior to 1973, most book publishers followed their consistent practice (for book and tax purposes) of deducting preproduction editorial and similar costs without disruption by the IRS. In

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1 In practice, more and more instructional, reference, and professional materials are appearing in both computer and print form, leading to the anomalous situation in which the costs of creating and developing a printed mathematics workbook, for example, are not eligible for the deduction, but the cost of developing a program for presenting the same information on a computer screen would be eligible.

1973, however, the Internal Revenue Service issued Rev. Rul. 73-395, 1973-2 C.B. 87, expressing the IRS position that preproduction editorial costs must be capitalized as part of the cost of the book copyright and are not deductible under section 174 on the ground that "costs incurred in the writing, editing, design and art work directly attributable to the development of the textbooks and visual aids do not constitute research and experimental expenditures under section 174."

This proposed treatment for the book publishing industry was strongly criticized as discriminatory and unjustified, and corrective legislation was introduced on a number of occasions. In 1974, for example, Congressman Dan Rostenkowski co-sponsored legislation to this end and, in doing so, referred back to the 1954 enactment of section 174, stating:

> "There is no suggestion in these reports that section 174 would not apply to the costs of research and experimentation necessary to develop products of book publishers, such as textbooks, reference books, visual aids, and other teaching aids, merely because the taxpayer's business is publishing or because the teaching aid or other product of a publisher is in the form of a printed book rather than in the form of a mechanical device. Section 174 should not be interpreted to discriminate against book publishers in the business of developing or in improving reference books, teaching aids or other products."

Further criticizing IRS' interpretation of the Reg. § 1.174-2(a)(1) disqualification of "research in connection with literary, historical, or similar projects," Mr. Rostenkowski urged that "this regulatory exclusion should be confined to its proper scope, for example, to preclude the amateur novelist from deducting his essentially personal expenses in the guise of business research expenses."

Section 2119 (Revenue Act of 1976)

In 1976, Congress responded to these criticisms of Treasury's position by enacting section 2119 of the Revenue Act of 1976 to block IRS' use of Revenue Ruling 73-395 and to allow publishers to continue to treat their editorial and other "prepublication expenditures" "in the manner ... applied consistently by the taxpayer to such expenditures before the date or issuance of such revenue ruling." Congress further cautioned IRS that any future regulations relating to this issue "shall apply only with respect to taxable years beginning after the date on which such regulations are issued."

No action has been taken by Treasury to date to comply with this Congressional direction. Consequently, the effect of the

1976 law was to maintain de facto parity between publishing and other industries.

This detailed and specific congressional directive concerning prepublication expenses of book publishers was never mentioned in the extensive legislative history of the uniform cost capitalization rules that became section 263A in the 1986 Act. No reference to section 2119 appears anywhere in the text or legislative history of the 1986 Tax Reform Act. No hearings were held on this issue, and no opportunity was given to the publishing industry to present its views.

Temporary and Proposed Section 263A Regulations

However, Treasury's temporary and proposed section 263A regulations now take the position that section 2119 of the 1976 Act was in essence repealed by section 263A, and that all book publisher's product development costs must be capitalized under section 263A and cannot be deducted under section 174. This position is inconsistent both with the 1986 legislation and with basic principles of statutory construction.

Repeal by implication, says the classic maxim of statutory interpretation, is generally disfavored. Further, as a matter of substance, a very general later law should not be viewed as repealing a highly specific earlier one.

Even if section 263A did override the 1976 provision, capitalization of the publishers' costs at issue is not necessarily required. For section 263A states that the new rules apply only to real property and "tangible" personal property. In turn, the latter term is statutorily defined as including "a film, sound recording, video tape, book, or similar property." As to the book publishing industry, this would appear to mean the costs of the actual tangible product--platemaking, printing, as well as other production costs.

1986 Conference Report

The Conference Report repeats that "application of the uniform capitalization rules with respect to production activities is limited to tangible property." But in a last-minute footnote added to Conference Report (II-308), the term "tangible property" is broadly expanded to include a number of intangible items:

> " ... films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book."

Despite this murky 1986 legislative background, the proposed section 263A regulations elevate the Conference Report footnote to a statutory level. They declare that section 263A, as a new Code section, is not included within the coverage of section 2119 and that, in any case, section 263A repeals section 2119. They do so by denying section 174 treatment for, and flatly requiring capitalization of, "prepublication expenditures incurred by publishers of books and other similar property, including payments made to authors of literary works, as well as costs incurred by such publishers in the writing, editing, compiling, illustrating, designing and development of books or similar property."

This Treasury position may aptly be described as legislation by footnote.

In light of the strained regulatory position taken by the Treasury--over the strong objections of the industry and expressions of concern by many members of Congress--on the meaning of section 263A, the only feasible solution for book publishers is to seek corrective legislation, to clarify that section 174 provides them with equivalent product development deductions comparable to those given to other businesses.

PROPOSED CORRECTION

The AAP urges that the appropriate resolution of this issue is to afford publishers of instructional, reference, and professional materials the same treatment for their R&D costs as is afforded other businesses. Such action would be fully consistent with the terms and purposes of the 1986 Act and would prevent the severe adverse impacts that would flow from Treasury's misreading of the 1986 Act as applied to publishers' R&D costs.

Request for Parallel Tax Treatment

The book publishing industry is not asking for special treatment, but only for equal treatment with other industries.

Under the correction we propose, section 174 would explicitly be declared applicable to research and development expenditures of a publisher of "instructional materials." Qualification as "instructional materials" would be expressly limited to materials prepared for publication with the principal purpose of use in systematic instructional activities in elementary, secondary, or vocational schools, or in post-secondary schools; as reference works or technical materials for use by persons in the conduct of their professions; or as instructional reference works, i.e, materials published for self-instructional activities in the liberal arts, the sciences, or similar disciplines and standard reference works such as encyclopedias, dictionaries, and thesauruses. Publications not coming within these definitions of "instructional materials" would not be covered.

Further, even for the limited category of publications covered, only those prepublication costs that qualify as R&D costs would be eligible. As explained above, for the publishing industry, those qualifying costs are the costs of identifying the need for a new or improved product, of gathering laboratory data related to it, of conceptualizing the product, of developing and field testing prototypes, of developing the manuscript, of designing and field testing the final layouts, of making content and design changes as a result of such field testing, and of pilot testing and adoption procedures. Not within the purview of section 174, but instead subject to capitalization, would be the following: Advance royalty payments to authors and costs of actual manufacture of the books or other products, including platemaking costs (material, typesetting, film making and labor), as well as production costs (paper, ink, binding, jackets and labor).

<u>In sum</u>, this committee's adoption of the proposed amendment would:

-- Correct an improper interpretation of the 1986 Act,

-- Eliminate the unjustified discrimination produced by Treasury's interpretation,

-- Foster innovation and creativity by educational book publishers,

-- Support their efforts to improve and modernize teaching, reference, and professional materials, and

-- Serve the public interest by strengthening sensible national educational policies and priorities.

Association of American Publishers

Washington, D.C.
July 22, 1987

STATEMENT OF ROBERT K. MASSIE, PRESIDENT, THE AUTHORS GUILD, INC., IRVINGTON, NY

Mr. MASSIE. Mr. Chairman, I am Robert K. Massie, President of The Authors Guild. The Guild represents 6500 members and it is the largest organization of professional freelance authors in the United States.

In 1964, I went to a publisher with the idea for my first book, Nicholas and Alexandra. I was given a book contract and I received a $2500 advance. It took me four years of research and writing to finish the book. Eventually, it was published, sold exceptionally well, but I can assure you that during those 4 years of relative starvation, when I was supporting my family as a magazine journalist, if the new tax law had been in effect then there would not have been a Nicholas and Alexandra.

I am here today because American writers face catastrophe. The problem is this same footnote added in the Conference Report to Section 263(a) of the 1986 Tax Reform Act. It extends uniform capitalization rules to authors' expenses. Unless a change is made, unlike many other enterprises that must capitalize, authors will get no current ordinary business deductions and no research and development deductions. Thus, authors will not be able to deduct any expenses incurred in writing a book until income is received from that book. If there is no income from that book in a given year, no deduction will be allowed.

Formerly, authors who were researching and writing a book while supporting themselves by writing magazine articles and perhaps receiving income from a previous book were able to deduct their expenses from the new book against other writing income. They will no longer be able to do that.

Under the new rules, if an author does have income from a new book pending, he or she can deduct only a proportion of his or her expenses in a given year. In addition, authors will be required to allocate every expense they incur among all of the different projects on which they are working.

Moreover, the new expense allocation and amortization rules single out writers from all other professionals—that is, lawyers who work on contingent fees, and others—and provide extremely harsh treatment by denying authors virtually all current expenses.

Authors will also be required to make forecasts of useful lives of their projects, in order to calculate what fraction of a given year's expenses may be deducted. We simply cannot make them, and I do not think the IRS will be able to make them when authors, helpless and desparate, take all of their data to the IRS in the various parts of the country in which they live and ask them to figure it out.

Few things in life are as uncertain as the success of a book. While I was writing "Nicholas and Alexandra" I could in no way have predicted what my income would have been or the fact that 20 years from now I would be receiving small driblets of income from that book. Nor at that time could I have afforded an accountant to explain the rules, maintain my records, and make the required amortization calculations

Furthermore, if a book project is unsuccessful—and this happens, unfortunately, all too often—capitalization rules may force an author to abandon his copyright in order to deduct his expenses.

I have since written "Peter the Great," which took 12 years to write, won a Pulitzer prize, and became a mini-series. By this time I was what you could call a successful writer. But I can tell you that I could not have written that book under these new rules.

Authors as a group make very modest income from writing. The median is about $7900 a year. Although these new capitalization rules will have little revenue impact on the Treasury, they will prevent many authors from writing books. And, therefore, we ask that an exemption to capitalization rules be provided for the research and writing expenses of freelance professional authors.

Thank you very much.

Senator BAUCUS. Thank you, Mr. Massie, very much. Mr. Silver.

[The prepared written statement of Mr. Massie follows:]

TESTIMONY OF

ROBERT MASSIE

On behalf of:

The Authors Guild
Pen (Poets, Essayists and Novelists)
Writers Guild of America -- West
Washington Independent Writers

The Tax Reform Act of 1986 adopted uniform capitalization rules for costs of "producing tangible personal property". Capitalizing such costs generally is appropriate in matching expenses with related income items.

However, a footnote added to the Conference Explanation expanded the new capitalization requirement to include expenses of professional freelance authors. (This matter is not addressed in the statute, and was not considered by either the House or the Senate.) Under this new requirement, authors will be required to allocate every expense they incur among each of their pending projects; and then to amortize such costs over the projected recovery life of the projects. (Thus, authors who are researching and writing books, while supporting themselves from writing magazine articles, etc., could not deduct their expenses for that book against income from their other writing projects.)

The required allocations and projections of useful lives for each project will be far more complex and uncertain than even the capitalization requirements applicable to manufacturers. As applied to authors, the new capitalization requirements effectively will represent pure guesswork.

The new expense allocation and amortization rules single out writers from all other professionals who provide services (e.g., lawyers that work on contingent fee arrangements), and provide extremely harsh treatment by denying deductions for all current expenses. The treatment of authors' manuscripts as tangible property also runs directly counter to the rule of Section 1221(3) of the Internal Revenue Code -- which denies capital asset status for authors' work products.

Prior law permitted professional authors to deduct their current expenses, just as architects, attorneys and others do. In fact, when the IRS attempted previously to apply capitalization rules adopted to deal with book and movie tax shelters to authors, the Second Circuit Court of Appeals rejected the IRS' view, stating that the compliance problems would be "immense".

The new rules will entail significant recordkeeping burdens, and likely will result in many controversies between IRS and taxpayers. (It has been suggested that every author maintain a log of time spent on each project in order to apply these new rules!) If a project is not successful, authors will have to abandon their copyright protection in order to deduct their expenses -- surely a questionable policy.

Since authors as a group generally have very modest earnings (median income from writing is $7,900 per year), these burdensome new rules will have little revenue effect. Although it is appropriate to apply capitalization requirements to manufacturers, publishers, etc., there is no justification for extending these complex and uncertain requirements to authors.

MEMORANDUM REGARDING THE NEED FOR A TECHNICAL CORRECTION TO SECTION 263A TO EXCLUDE PROFESSIONAL WRITERS' RESEARCH AND WRITING EXPENSES FROM THE UNIFORM CAPITALIZATION RULES

This memorandum is submitted by The Authors Guild, Inc. regarding the need for a technical correction to the Tax Reform Act of 1986 (the "Act") to exclude from the uniform capitalization rules the research and writing expenses of professional authors. Such an amendment is necessary because of the undue burden that application of these complex and uncertain rules will impose on professional writers -- a burden that, it is submitted, is wholly disproportionate to any governmental interest in the application of the capitalization requirements in this setting. Stated simply, the rules of Section 263A as they apply to authors' expenses are virtually unworkable; and their application to a group of individuals who in general derive only modest income from writing is completely at variance with sound tax policy. The amendment is further justified to prevent the discriminatory application of Section 263A to only a single group of persons that derives income from services.

Background

The uniform capitalization rules contained in Section 263A of the Internal Revenue Code of 1986 were enacted because:

> "The Congress believed that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules

should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome."[1]

In general, the capitalization of such costs is in furtherance of the basic tax accounting objective of matching income and related expense items.

Prior to adoption of the Act, the ordinary and necessary business expenses of professional authors were deductible when paid under Section 162.[2] Although the Internal Revenue Service contended that former Section 280 (enacted in 1976 to require capitalization of expenses relating to production of films, books, records, etc.) barred the deduction of authors' research and writing expenses, that assertion was rejected by the Court of Appeals for the Second Circuit, which held that the intended reach of that section was tax shelter operations and book publishers, rather than authors.[3]

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1 Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 508-09 (1987).

2 No assertion is made that expenses associated with writing activity that fails to satisfy the "hobby loss" provisions of Section 183 are, or should be, deductible under Section 162.

3 See Hadley v. Commissioner, 819 F.2d 359 (2d Cir. 1987), rev'g 86 T.C. 764 (1986) and 51 T.C.M. 948 (1986). Former Section 280 required capitalization of amounts attributable to the "production of a . . . book . . . ." Section 280(a), as in effect prior to the Tax Reform Act of 1986.

The possibility that the Act's uniform capitalization rules might apply to the research and writing expenses of authors first emerged in the Conference Explanation of the Act. The treatment of authors' expenses is not addressed in new Section 263A itself, or in the House or Senate bills or accompanying reports. Moreover, it is entirely plausible to read new Section 263A, like former Section 280, to be altogether inapplicable to authors' research and writing expenses.[4]

Nonetheless, the following sentences appeared in a footnote in the Conference Explanation of the Act:

> "For this purpose, tangible property includes films, sound recordings, video tapes, books, and other similarly [sic] property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book.[5]

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4 In relevant part, Section 263A applies to the "production" of "tangible personal property." Section 263A(b)(1). The term "produce" is defined for this purpose to include "construct, build, install, manufacture, develop, or improve." Section 263A(g)(1). Only through a strained reading of these words could the act of writing a manuscript be included among the targeted activities. Moreover, while the statute defines "tangible personal property" to include a "book" (Section 263A(b) flush language), the logical effect of that provision would seem to be to subject the manufacturer of the book (e.g., the publisher, binder, printer, etc.) to the new rules, rather than the author of the manuscript that underlies the book to be published. The similarity of the structure of Section 263A and former Section 280 underscores the argument that neither section is applicable to authors.

5 H. Rep. No. 99-841, 99th Cong., 2d Sess. II-308 n.1 (1986) (emphasis added).

The Authors Guild, Inc. respectfully submits that the purported reversal of prior law by means of the footnote just quoted does not represent sound tax policy, and should expressly be rejected through an amendment in the Technical Corrections bill.

Operation of Section 263A
as It Applies to Authors

The burden that will be imposed on authors by application of the uniform capitalization rules can without exaggeration be characterized as extraordinary.

The general requirement of Section 263A in the present context is that all expenses allocable to writing activities that otherwise would be deductible under Section 162 must instead be capitalized to the account of the project in question. Such expenses then are recoverable as income is derived from the project, based on total revenues expected to be derived from the project.

The first step in the application of this rule requires fragmentation of all writing-related expenses across the writer's affected projects.[6] In a typical situation, a writer may be involved in writing a book, writing one or more articles, and perhaps working on certain related endeavors, such as preparing a speech. How might the author

6 Such expense might include telephone, freelance typist, utilities, cost of periodicals and the like.

allocate the expenses that, not uncommonly, might be attributable in part to each of these projects? Although Treasury Regulations have been issued under Section 263A, no answer to this question is suggested. General tax principles would call for an allocation based on the relative fair market values of the projects, which presumably would be derived by discounting to present value the cash flows projected for each of the writing projects -- obviously a highly uncertain exercise as an author embarks upon the preparation of a manuscript.

In an effort to simplify the resolution of this cost allocation issue, it has been suggested by government staff that the author keep records of the time spent on each project, and allocate expenses -- presumably other than those specifically allocable to a given project -- on the basis of relative time spent. One might wonder whether the tax law should demand that the Nation's writers log their time spent on each poem, short story and essay in order to meet the requirements of Section 263A. In all events, however, keeping such time logs still will fail to produce the needed data where time is spent in a manner (e.g., research) that might benefit multiple projects.

Following on the exercise of allocating the writer's expenses to each of the projects in process, the question then to be addressed is the manner in which the capitalized costs may be recovered. We understand the applicable principles to be the following:[7]

7 Rev. Rul. 60-358, 1960-2 C.B. 68.

(i) In general, the "income forecast" method must be used to determine the deductible portion of capitalized expenses by reference to the ratio of (x) annual revenues derived from the project to (y) total expected revenues for the project.

(ii) Annual re-assessments of the total expected revenues are required to be made.

(iii) In any years in which no income is earned from the project, no deduction may be claimed.

(iv) Even if the project proves a failure, no deduction may be claimed unless the project is shown to have been abandoned.

Again, the theory that underlies the required analysis is not in question. The reality, however, is that any meaningful estimate of the projected royalties from a book or article will often be largely guesswork.[8] For example, what of the poem that is first printed in a magazine, later is collected in a volume of the author's poems, and still later is aggregated as part of the author's collected works? As

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8 The Court of Appeals for the Second Circuit characterized the attempt to apply the income forecast method to authors' expenses in Hadley, supra, as follows:

> "In an activity as ephemeral as writing a book, the difficulties in estimating a future income stream and determining the time of ultimate write-off when it becomes clear that either a book will not be published or, if published, will not sell, appear immense."

another example, if poet A has had several poems anthologized, should poet B assume that his first poem published in the <u>New Yorker</u> also will one day appear in an anthology? Obviously, without information as to the expected pattern of publication, no meaningful estimate of future income can be derived. More fundamentally, even authors with a solid track record of publication at times find that later books do not sell well. The converse is also true. If it is not abundantly clear, these rules are unadministrable, and do not work.[9]

A final point regarding operation of the rules. Suppose a given project is a failure; when (if ever) may the taxpayer deduct the capitalized expenses? It has been suggested by government staff that the taxpayer must abandon his or her entire right in the project to qualify for a deduction. Presumably, that will require abandoning the author's copyright protection -- so that the work will become part of the public domain. Without debating the technical tax aspects of such a rule, from a public policy viewpoint such a requirement is most charitably characterized as unfortunate.

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9 That is not to say that the income forecast method can never produce appropriate results. In the context of a movie company, or publishing house, the volume of amortizable films or books should yield reasonable results due to an averaging process. An individual author -- who may produce a major work only once in several years -- obviously has no such benefit of an averaging phenomenon.

Compliance and Administration Issues

Each of the above fact-intensive issues will, of course, be subject to review by the Internal Revenue Service, with the ultimate resolution being time-consuming and expensive for both taxpayers and government. More fundamentally, this new system based largely on guesswork and surmise is certain to prove a source of taxpayer compliance difficulties. One would have thought that the government would strongly disfavor rules that will encourage aggressive position-taking based on the highly subjective matters such as those involved here.[10]

The merits of attempting, in any context, to provide a "matching" rule based upon such elusive matters as the required allocation of authors' costs, and the revenue estimated to be derived from projects, might fairly be debated. Whatever value the change might possess in the abstract, however, is completely swallowed up by the administrative and practical difficulties that will be faced by the group affected by this change. Virtually all of the affected taxpayers are individuals. It may be speculated that many prepare their tax returns without professional assistance. For these persons, it simply is the case that the tax law will be incomprehensible. These persons

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10 One need only examine the numerous factual-issue cases that fill the Tax Court docket, or the various recent Code penalty provisions relating to valuation (e.g., the Section 6659 and 6660 valuation overstatement and understatement penalties) to confirm the difficult problem of tax administration that arises from the presence of factual issues in the tax law.

then will have the choice of incurring the expense of retaining a professional return preparer, or, in many cases, of failing to comply with the law. It is defensible to impose sophisticated tax accounting concepts to more accurately measure income on taxpayers who ordinarily employ such concepts in their business. It is totally indefensible to impose rules fraught with interpretive difficulty on persons who will frequently be without means to understand or deal with such rules.

Writers vs. Other Service Providers

Authors are not alone among service-providers in incurring expenses in advance of related receipts.[11] A lawyer may work for years on a case, particularly where a contingent fee is involved, and be permitted to deduct expenses when paid, far in advance of receipt of any fee income. Similarly, an architect may work on a set of plans for a building over multiple years, and deduct expenses well in advance of payment for the services.

There is no apparent basis for providing discriminatory treatment for authors in relation to other service providers. As the language of Section 263A clearly states, it is intended to reach persons that produce tangible property -- i.e., property other than a lawyer's

11 Commentators have observed that authors are properly characterized as receiving income from the sale of services, rather than from production of an asset. Note, Tax Treatment of Prepublication Expenses of Authors and Publishers, 82 Mich. L. Rev. 537 (1983). See also Hadley, supra.

brief or an architect's plans and specifications. Any decision by the Congress to extend the reach of Section 263A to the expenses of service providers should be deliberate and uniform.

Revenue Implications

Although one can only speculate as to the amount of revenue that will be produced by this change in the tax treatment of authors' expenses, available information indicates that the amounts involved are small, if not trivial. Initially, it must be borne in mind that the issue is not the allowability vel non of deductions: the issue is any revenue loss resulting from deferral of tax collections. Two observations are appropriate: one, the group in question, professional writers, have extremely modest earnings; median income from writing is estimated to be $6,900 per year. Second, an exception to the uniform capitalization rules for such persons is not a loophole that might be exploited by the ingenious in order to gain an unintended advantage.

Conclusion

An exception should be provided to Section 263A for the research and writing expenses of professional authors.

The Authors Guild, Inc.

July 17, 1987

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE, WASHINGTON, DC

Mr. SILVER. Mr. Chairman, my name is David Silver. I am President of the Investment Company Institute, the association which represents America's mutual fund. The subject of our comments is Internal Revenue Code Section 67(c), a provision added as a technical amendment in last year's Tax Reform bill. Unless corrected, section 67(c) will impute phantom taxable income to nearly 20 million taxpayers next January. This section was added in the last hour of the Senate consideration of the tax bill without hearings or debate as part of a package of hundreds of amendments labeled as technical and represented as having no substantive impact.

The infirmities which afflict section 67(c) flow from its genesis as a technical amendment shielded from the rigors of debate or time for reflection.

First, the section is unfair to 20 million individual taxpayers by saddling them with phantom income. To the average taxpayer, phantom income will truly be an amazing concept. The section works like an alchemist formula, transmuting a mutual fund's business expenses into income for fund shareholders. As with other attempts to turn lead into gold, this one also fails, for the so-called income to be received by these 20 million shareholders cannot be banked, cannot be invested, and cannot be used to buy groceries. The only thing it is good for is to pay taxes on.

Section 67(c) is, therefore, grotesque as a matter of tax policy.

A second infirmity arises in the fact that these 20 million shareholders will receive 1099s which show more taxable income than shown on their account statements. Confused and resentful, many of them will pay their taxes on the dollars they know they received, not on fictional amounts. The results will be administrative chaos as there will be a gigantic mismatch between tax returns and 1099s.

Section 67(c) is, therefore, absurd from the viewpoint of tax administration.

Third, the section is unfair as a competitive matter. As shown in attachment B to our written statement, no financial product competitive with mutual funds is saddled with phantom income.

Section 67(c), therefore, violates another cardinal tenet of tax policy, that of neutrality.

To my left are charts illustrating the impact of the section on the actual tax liability of a 78-year-old retired widow with mutual fund investments which produced $6,898 in income in 1986. The cost of this provision to her in taxes, assuming level income this year, will be an increase from $495 in 1986 to $511 in 1987. Without phantom income, her 1987 tax bill would have only been $393. She would have received the benefits of tax reform. But Section 67(c) has eliminated, and I believe inadvertently, her entire benefit of the Tax Reform Act of 1986.

Mr. Chairman, in conclusion, the policy considerations I have mentioned this morning, the bizarre results illustrated on these charts in human terms is why you, Senator Moynihan, and 13 of your Finance Committee colleagues have joined together to introduce S. 1489 to correct section 67(c).

In conclusion, Mr. Chairman, I might simply mention this is the first minute of consideration by any congressional committee that this provision, which taxes 20 million shareholders, has been given.

Thank you very much. I would be happy to answer any questions.

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

Our next witness is Mr. Herbert Lerner.

[The prepared written statement of Mr. Silver follows:]

TESTIMONY OF
DAVID SILVER, PRESIDENT
INVESTMENT COMPANY INSTITUTE
BEFORE THE
COMMITTE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
ON TECHNICAL CORRECTIONS TO THE
TAX REFORM ACT OF 1986
JULY 22, 1987

I. INTRODUCTION

Mr. Chairman. I appreciate the opportunity to testify today. My name is David Silver. I am president of the Investment Company Institute, the association which represents America's mutual fund industry. The Institute's membership includes 2,086 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members hold assets accounting for approximately 90% of total industry assets and have over 29 million shareholders.

Mutual funds clearly have become a highly preferred investment vehicle for millions of middle income investors and working Americans trying to accumulate savings and retirement income. They provide investors of moderate means the opportunity to obtain professional investment management and diversification of their investments. Over half of all mutual fund shareholders (excluding those in tax-exempt funds*) have household incomes of less than $50,000; forty percent have adjusted gross income under $40,000. Excluding money market mutual funds, thirty-eight percent of all fund shareholders are retired. Many of these retirees depend heavily on their mutual fund investments for day-to-day living expenses.

* Shareholders in tax-exempt funds have been excluded from these statistics because it appears that such funds may be largely unaffected by Section 67(c).

The subject of our comments today is Internal Revenue Code Section 67(c): a provision added to the tax code in last year's tax reform measure. Absent timely congressional action, Section 67(c) could adversely affect almost every mutual fund and mutual fund shareholder in America. As currently written, Section 67(c) will impute phantom taxable income, i.e., income not received but included in taxable income, to nearly 20 million U.S. taxpayers this year. Mutual fund households will have to pay taxes on $100 -$200 or more of income they never receive.

We are most pleased, Mr. Chairman, that 15 members of the Senate Finance Committee recently joined in introducing S. 1489, a bill authored by Senator Moynihan to remove the discriminatory impact of Section 67(c) upon mutual funds and mutual fund shareholders. We hope that this Committee will agree that S.1489 would be a suitable technical change to last year's tax reform law which ought to be enacted as part of the earliest available legislative "vehicle."

Please consider the following reasons for enacting S.1489 as promptly as possible.

II. SECTION 67(c) VASTLY OVERSHOT THE MARK INTENDED BY CONGRESS LAST YEAR.

A. Section 67(c) Was Intended To Be a Narrow Anti-evasion Provision.

I.R.C. Section 67, added to the Code last year, imposes a two percent floor on certain "miscellaneous itemized deductions," including deductions under Section 212 for expenses incurred in producing investment income. Section 67(c) was added as one of hundreds of technical amendments at literally the last hour of the Senate's consideration of the Tax Reform Act. On its face it appears to be solely an anti-evasion or "loophole closing" provision: to prevent the indirect deduction through "pass-thru entities" of amounts not deductible if incurred by an individual directly.

Theoretically, I suppose, some sort of specialized "mutual fund" might be established by a handful of taxpayers seeking to avoid Section 67's restrictions -- although I believe that hypothetical possibility is farfetched. Were that to occur, the application of Section 67(c)'s "loophole closing" intent would be appropriate.

However, Section 67(c), as written, went far beyond that narrow prophylactic purpose. Regulations may be issued to effectuate Section 67(c) that would impute phantom taxable income to virtually all individual mutual fund shareholders in an amount equal to a portion of the operating expenses of their mutual fund. These operating expenses have, in the past, been recognized by the Internal Revenue Service as ordinary and necessary business expenses. Under the new provision, however, a fund shareholder will be treated as having personally incurred the expenses and (if he or she itemizes) will be permitted to deduct the expenses only if, together with the shareholder's other miscellaneous itemized deductions, the expenses exceed the two percent floor.

B. Section 67(c) Inappropriately Affects 20 Million Shareholders of Publicly Offered Mutual Funds.

It is patently ludicrous that a narrow anti-evasion provision should impute phantom income to 20 million shareholders of publicly-offered mutual funds. The more so when one considers that Section 67(c) will apparently impute income to nonitemizers as well as itemizers and that nonitemizers will in no event be able to deduct these expenses. Of these mutual fund shareholders who do itemize their deductions, only a small percentage will have expenses in excess of the two percent floor. Section 67(c) will thrust a peculiar new tax burden upon 20 million taxpayers which defies reality.

Who are these taxpayers? I can assure the Committee they are not wealthy manipulators of the tax code. Nor are they conversant with such arcane concepts as phantom income. Many shareholders are pensioners or working Americans building their retirement savings. They thought the Congress was reducing their overall tax burden last year via increases in the standard deduction and personal exemption amounts and decreases in the effective tax rates. They will be astonished next January to see on their Forms 1099 that the Congress actually cut those tax benefits by imputing to them significant amounts of phantom income.

C. The Phantom Taxable Income Created by Section 67(c) Unfairly Increases the Tax Burden of Mutual Fund Shareholders.

The impact of Section 67(c) will first be felt by mutual fund shareholders next January. They will receive a Form 1099 which includes in taxable income an amount greater than that which is reflected in their year-end statements of account or their own checkbooks.

The effective rate of tax on all mutual fund dividends will be increased significantly by Section 67(c). In the case of shareholders in equity funds, the effective tax rate on dividends will be increased by 20 percent or more for investors of every income level.

The penalty imposed by Section 67(c) falls even more heavily on older shareholders than it does on younger shareholders. This is because retirees depend heavily on their mutual fund investments for living expenses. In addition, elderly shareholders are less likely to be able to deduct any portion of the imputed income, because they either use the standard deduction or have insufficient miscellaneous deductions to exceed the 2 percent floor. I would draw the Committee's attention to Attachment A which illustrates the impact of Section 67(c) on elderly shareholders.

D. The Enforcement of Section 67(c) Will Be An Administrative Nightmare.

And what will be the impact upon mutual funds and the U.S. government? In a word, chaos! Ease of entry and swift redeemability have been a hallmark of mutual fund investing. Trillions of dollars are invested and withdrawn from mutual funds each year. A severe administrative logjam could develop in identifying millions of individual shareholders and then allocating phantom income to them. It will be a worse problem for the government. The IRS will face an administrative nightmare in trying to collect the tax attributable to Section 67(c). The income reported on Form 1099, which will include Section 67(c) "phantom income", will disagree with shareholders' own records and yearly account statements received from the funds. Millions of shareholders will be confused by this discrepancy and will simply report on their tax returns the income they know they received. The result will be a mismatch between tax returns and 1099s, leaving the IRS in the unenviable position of trying to collect $30, $40 or $100 from millions of citizens who do not believe that they have underpaid their taxes.

E. Section 67(c) Puts Mutual Funds At An Unfair Competitive Disadvantage.

Finally, Section 67(c) might at least have made logical sense had it been applied to all competing investment products. But it applies to mutual funds alone. Even real estate investment trusts investing in securities are excepted from this provision even though REITs are taxed under the provisions of Subchapter M of the Code along with mutual funds. Virtually every investment product which competes with mutual funds is unaffected. This discrimination against mutual funds and mutual fund shareholders is illogical and is objectionable tax policy. I have attached, as Attachment B, a brief analysis which illustrates the discriminatory nature of Section 67(c).

III. SECTION 67(c) WAS INAPPROPRIATELY ADOPTED AS A TECHNICAL AMENDMENT.

A. This Provision Was First Introduced on the Floor of the Senate Buried Among Hundreds of Technical Provisions.

I scarcely need remind the Committee that Congress is not in the habit of imputing phantom taxable income to millions of Americans by way of technical amendment or otherwise. It should not have happened here.

Section 67 was included in the House version of the tax reform legislation and was subsequently modified by the Senate Finance Committee. However, the provision that became Section 67(c) first surfaced only in the last hours of Senate floor consideration in a ninety-page package of technical provisions. We believe that the Senate floor managers assumed that every provision in that package was purely technical, nonsubstantive. They so assured the Senate. Without debate, the Senate thereupon approved the entire package. Yet, in the end, there was Section 67(c).

B. Section 67(c) Would Never Have Survived the Deliberative Process.

I must tell you candidly that the mutual fund industry feels seriously aggrieved by last year's process. The deliberative tax reform process lasted for months. We participated actively while the tax reform bill moved through the Congress. There was never a hearing or even one minute of debate on the Senate floor about a proposal to impute phantom taxable income to mutual fund shareholders or to discriminate against mutual funds. To put it bluntly, we were denied any meaningful opportunity to oppose -- or even to comment on --Section 67(c). But the failure of the normal legislative process to work was not merely a technical infirmity -- it had serious consequences.

Had Section 67(c) ever been proposed during the Senate's deliberative process, it never would have survived. Retrospective consideration of Section 67(c) finds a conspicuous absence of support:

- Secretary Baker has written to members of Congress stating that Section 67(c) was not required for revenue neutrality last year and urging its reconsideration;

- The House Conferees last year opposed the application of Section 67(c) to mutual funds and we believe that the House Ways and Means Committee still maintains that position; and,

- Three quarters of the Senate Finance Committee members have sponsored S.1489, legislation modifying Section 67(c).

C. Section 67(c) Was a Dramatic, Substantive Change, Not a Technical Provision.

Now that the scope of Section 67(c) is understood, no one can seriously maintain that extending Section 67(c) to mutual fund shareholders generally was "technical." Section 67 of the Code is a provision which limits the deductibility of certain miscellaneous itemized deductions by individuals. Prior to the introduction of Section 67(c), mutual fund shareholders were unaffected by the debate on Section 67, because mutual fund expenses were appropriately treated as business expenses of the fund, not investment miscellaneous expenses of individuals deducted under section 212. By converting business expenses of a mutual fund into miscellaneous expenses of its individual shareholders, the introduction of Section 67(c) resulted in a dramatic, substantive change. Not only was this change inappropriate as a technical amendment, but any reasoned consideration of this change would have revealed it to be poor tax policy.

D. The Scope of Section 67(c) Was Unintentionally Broad.

The application of Section 67 to mutual funds through Section 67(c) is also not defensible as an anti-evasion device. No one would say that absent Section 67(c), 20 million mutual fund shareholders would suddenly be using their mutual funds to sidestep the restriction on Section 212 deductions. People invest in mutual funds to obtain professional investment management and diversification, not to engage in tax avoidance schemes.

S.1489 would restore the original congressional purpose of this provision. It would leave Section 67(c) intact as an anti-evasion, loophole closing provision. With regard to mutual funds, it would restrict Section 67(c)'s application to taxpayers who somehow endeavor to use a mutual fund investment to circumvent Section 67, while eliminating the need for Treasury to impose a discriminatory phantom income tax upon the vast majority of mutual fund shareholders.

IV. RELIEF FOR MUTUAL FUND SHAREHOLDERS SHOULD BE ENACTED IMMEDIATELY.

For the reasons stated above, S.1489 clearly should qualify for inclusion in the technical corrections bill. We are concerned, however, that enactment of the technical corrections bill will be delayed beyond the time when effective relief will be possible.

Retroactive relief from Section 67(c) would be costly and unmanageable. Once shareholders begin filing their 1987 tax returns in January and February of 1988, correction of Section

67(c) would be an enormous administrative burden. Moreover, the lead time required to prepare 1099 forms to be mailed next January makes immediate relief appropriate.

We, therefore, urge the Committee to enact S.1489 in the earliest available legislation.

V. REVENUE ESTIMATES ASCRIBED TO SECTION 67(c) AFTER THE FACT SHOULD NOT DETER CONGRESS FROM CORRECTING LAST YEAR'S ERROR.

A. Section 67(c) Was Introduced As a Technical Provision, Not Intended to Produce Any Revenue.

Secretary Baker has written to members of Congress that Section 67(c) was not required for revenue neutrality in last year's tax law. Indeed "technical provisions" are not supposed to yield independent revenues. We believe that no revenue was attributed to this provision either at the time it was proposed as a technical amendment on the Senate floor or at the time the President signed the bill into law.

We appreciate the Committee's concern about the revenue impact associated with various amendments to the tax law. I am sure you can appreciate our concern over the suggestion that revenue implications might prevent Congress from amending Section 67(c). Even though it is wrong as a matter of policy; was never intended to affect 20 million taxpayers; was never intended to impose a harsh competitive inequity on an industry; and was never intended to create administrative chaos for the government.

Here is a provision -- now generally disdained -- adopted only because it was proffered as a technical amendment and thus presumably not intended to produce independent revenue impact. Yet changing it may prove impossible because revenue came to be associated with it once it had been enacted? This is a Catch-22 of the highest order.

Mr. Chairman, it would be most unfortunate if technicalities of the budget estimating process were to prevent the Congress from modifying a provision that will adversely affect 20 million taxpayers. The Committee should disregard the revenue impact ostensibly associated with Section 67(c). I am not familiar with the technicalities of the budgetary process. But it makes sense to me that something introduced as a technical amendment, not designed to produce revenue, should be corrected as a technical amendment, without being saddled with revenue consequences.

B. The Revenue Attributed to Section 67(c) Should Be Reduced Under An Appropriate Construction of the Law.

While we believe that equity requires correction of Section 67(c) without consideration of any revenue impact, the whole discussion of revenue should be put in perspective. We urge the Committee to consider the following points.

Secretary Baker has written that the upward limit of revenue impact could be as much as $530 million per year. This purely theoretical figure is valid only if Treasury, in regulations, imputes 100 percent of a mutual fund's expenses as income to its shareholders. This is an unrealistic assumption that does not comport with even the most extreme construction of the law.

The legislation directed that Treasury should determine those mutual fund expenses comparable to the expenses of an individual which are subject to the two percent floor. While we do not believe that the business expenses of a mutual fund are analogous to personal miscellaneous expenses, we have, nevertheless, done our best to draw the analogy.

The mutual fund industry has presented Treasury with two analyses--one which considered the industry at large and one which actually examined the practices of eight diverse funds--to ascertain that portion of a fund's expenses which could be viewed as comparable to those individual expenses subject to the floor and, therefore, to be allocated as income to shareholders under Section 67(c). These analyses demonstrate that the appropriate percentage is no more than 22 percent.

Under these analyses, the maximum annual revenue impact associated with congressional modification of Section 67(c) would barely exceed $100 million.

C. The Revenue Estimate Should Also Be Reduced for Non-compliance, Non-collection and Other Factors.

In practical terms, even the $100 million revenue figure ought to be discounted to recognize probable shortfalls attributable to noncompliance, noncollection and other factors. Experienced tax lawyers have predicted that many taxpayers will have already prepared their tax returns on the basis of year-end statements of account prior to receiving 1099s; many will not understand the imputed income and will not pay the additional tax. The IRS will face the choice of implementing costly collection procedures or foregoing the amounts of tax at issue. In either case, the potential revenue figure associated with Section 67(c) ought to be discounted.

VI. CONCLUSION

Mr. Chairman, thank you for this opportunity to testify. The defects in Section 67(c) are readily apparent and have been broadly acknowledged. A technical correction to restore the original congressional intent -- that Section 67(c) merely prevent evasion of Section 67 -- ought to be enacted in time to provide relief to taxpayers and to mutual funds this year.

ATTACHMENT A

IMPACT OF SECTION 67(c) ON OLDER SHAREHOLDERS

The significance of the fact that the numbers shown on these tables represent only average numbers may also be seen in Table 5, which illustrates the impact of section 67(c) on shareholders age 65 or older. Excluding money market fund owners, 38 percent of all mutual fund shareholders are retirees.
In general, the section 67(c) penalty falls more heavily on shareholders in this age group for three reasons. First, retirees and older individuals generally own more investments than younger individuals in the same income class. Second, elderly shareholders are less likely to be able to deduct any portion of the imputed income, because they either use the standard deduction or have insufficiant miscellaneous deductions to exceed the 2 percent floor. Most importantly, retirees and older shareholders often rely heavily on their investments for living expenses and, therefore, tend to notice any decrease in the return on their investments. The penalty imposed under section 67(c) on mutual fund investors age 65 or over is even more substantial than that imposed on younger shareholders and is, therefore, even more likely to be disturbing to these shareholders.

The impact of the section 67(c) tax penalty on the elderly may also be analyzed in terms of its effect on the tax benefits otherwise gained by the elderly under the new law. By changing the personal exemption and standard deduction amounts available to the elderly, the 1986 Tax Reform Act increased the amount of income which may be earned by an elderly couple before any tax liability is imposed. On average, at least one quarter of this benefit is offset by the section 67(c) imputed income.

Average Tax Liability on Mutual Fund Dividends and the Effect of the 67(c) Gross-Up 1/
- Shareholders 65 Years of Age and Over; All Mutual Fund Types

(1986 Levels)

Income Class (Thousands of 1986 dollars)	Tax Liability on Mutual Fund Dividends, No 67(c) Gross-up	Additional Taxable income due to 67(c) gross-up	Additional Tax liability due to 67(c) gross-up	Percentage change in taxes on mutual fund dividends due to 67(c) gross-up
less than 10	$191	$137	$ 21	10.8%
10-20	190	132	20	10.4
20-30	414	241	46	11.1
30-40	590	260	62	10.6
40-50	931	343	98	10.5
50-75	1,200	417	122	10.2
75-100	1,591	453	146	9.2
100-200	1,734	541	168	9.7
more than 200	1,747	714	201	11.5
Total	601	278	61	10.2

1/ All tax calculations are performed separately for each taxpayer within each income class. The average of the individual calculations is then computed and reported here. Therefore, the results for each income class are the average for all taxpayers within that class, including itemizers and non-itemizers, joint and non-joint filers, etc.

Source: Price Waterhouse

May 23, 1987

ATTACHMENT B

COMPETITIVE EFFECT OF SECTION 67(c)

The attached chart graphically illustrates the adverse competitive impact of section 67(c) on the mutual fund industry. For the entire spectrum of the $800 billion plus mutual fund industry, there exists one or more competing investment product which is not similarly disadvantaged. As illustrated, each major type of fund competes with other investment vehicles for the dollars of investors seeking to purchase a debt, tax-exempt debt or equity investment. Not one of these alternative investment vehicles* is burdened with the investor penalty of section 67(c).

Examples of two products which compete directly with particular sectors of the mutual fund industry are bank money market deposit accounts and managed brokerage accounts invested in equity obligations. The impact of section 67(c) on money market mutual funds and equity mutual funds may be sufficient to tip the competitive balance in favor of the non-mutual fund alternative product.

1. Money Market Funds v. Bank Money Market Deposit Accounts

At the present time, approximately one-third of all mutual fund assets, some $230 billion dollars, are invested in money market mutual funds. By contrast, the bank money market deposit accounts, a financial product created by Congress in 1983 for the express purpose of competing with money market mutual funds, currently hold some $570 billion. The yield on bank money market deposit accounts is typically set at a level very close to that paid by money market mutual funds. However, bank money market deposit accounts have the additional benefit of FDIC insurance. With the impact of section 67(c) on the effective after-tax yield on money market mutual funds, the competitive balance will, in many cases, tip clearly in favor of the bank money market deposit account.

2. Equity Mutual Funds v. Managed Brokerage Accounts

Although equity mutual funds are not typically as yield sensitive as money market mutual funds, they also have a directly competitive alternative investment product. Moreover, investors in equity mutual funds may be even more likely to be motivated than shareholders in other funds to seek out an alternative investment vehicle because of the greater impact of section 67(c) on such funds. The overall expenses of equity funds tend to be greater than those of other funds. Moreover, such funds, because they try to maximize capital

* Although it had been previously believed that commodity pools and other partnership investment products might also be affected by Section 67(c), it now appears that only mutual funds will be affected by the provision.

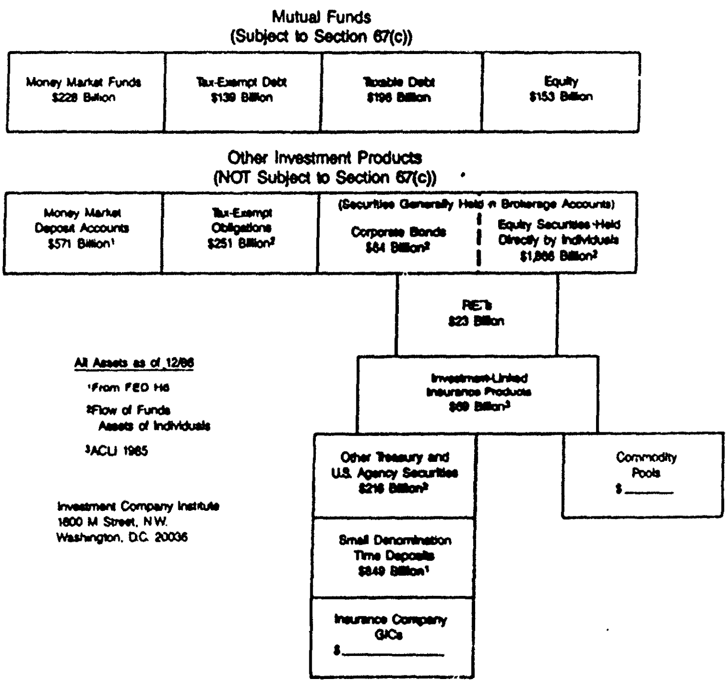
appreciation rather than ordinary income dividends, typically distribute relatively small amounts of divided income. For these two reasons (higher expenses and lower ordinary income dividends), section 67(c) may be expected to have a greater impact on shareholders of equity mutual funds than shareholders of other funds. As a percentage of yield, the shareholder's pro rata share of expenses subject to the two percent floor will be greater in an equity mutual fund.

Investors seeking an alternative investment without the tax disadvantages of equity mutual funds can establish managed equity portfolio accounts with brokerage firms. These portfolios, which typically include stocks taken from the brokerage firm's approved list can be offered to customers of the firm with no investment charge for the investment advisory services. Only brokerage commissions, which are not subject to the two percent floor, will be paid by the investor for transactions within the managed equity account.

* * * *

The essential viability of the mutual fund industry has traditionally rested upon the absence of any tax disincentive to investor in mutual funds. The mutual fund investor has been treated, for tax purposes, comparably to the direct investor in securities. Section 67(c) represents a significant departure from this basic principle. It places the mutual fund investors in a less favorable tax position than many other direct investors and thereby places funds at a considerable competitive disadvantage.

COMPETING INVESTMENT PRODUCTS



STATEMENT OF HERBERT J. LERNER, CHAIRMAN, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC, ACCOMPANIED BY DONALD SKADDEN, VICE PRESIDENT, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LERNER. Good morning, Mr. Chairman.

I am Herbert J. Lerner, chairman of the Federal Taxation Executive Committee, testifying today on behalf of the American Institute of Certified Public Accountants and its nearly 250,000 CPA members. Joining me today is Donald Skadden, the AICPA Vice President for Taxation.

We are here today to support legislation you and Senator Heinz have introduced which would remedy the effect of Section 806 of the Tax Reform Act of 1986, which mandated that most partnerships, S corporations, and personal service corporations conform their tax years to the tax years of their owners.

The 1986 Act has its greatest impact on small businesses since most closely held entities are owned by individuals who are on the calendar tax year basis.

Section 806 will impose undue costs and administrative burdens on small business. Affected entities would be required to close their books twice for 1987 and file duplicate tax returns. Furthermore, section 806 would continue to have transitional effect over the next four years and, because it applies to existing as well as new entities, businesses which have used a fiscal year for many years will now have to amend contracts, compensation arrangements, retirement and employee plans, all as a result of this provision.

It would also create a significant workload problem for CPA firms which will be required to compress tax return preparation, financial reporting and auditing work into a shortened period of time.

A recent survey of AICPA tax division members revealed that more than 60 percent of their annual workload will now fall in a 3½ month period as a result of the year-end requirement.

Even if extension requirements are liberalized, not enough of this work could be spread throughout the year since the accounting and financial reporting needs cannot as a practical matter be extended much beyond the close of the reporting year. Under your legislation, owners of electing partnerships and S corporations will be required to make enhanced estimated tax payments determined with reference to the amount of tax deferral based on the entity's preceding fiscal year. Thus affected entities could retain their fiscal year while than owners make enhanced estimated tax payments.

For simplicity and efficiency, the required amount would be included on existing K-1 forms as a line item to advise affected owners.

Any entity which is subject to section 806 and which newly elects or changes its fiscal year would be required to elect a year no earlier than September 30, a period consistent with prior IRS announcements about appropriateness of fiscal years for such entities.

Your legislation also provides a de minimus exclusion, whereby those who have less than a $200 impact with respect to all of their electing partnerships and S corporation interests are exempt from this requirement.

It is important to remember that those entities which would be allowed to remain on fiscal years under the 1986 Act are not affected by this provision.

Since your proposal would correct the provision of the 1986 Act, which has an unanticipated adverse impact on small businesses and their advisors, we believe it is appropriate to address it in S. 1350. It is especially appropriate because your legislation provides a solution which is crafted intentionally to be essentially revenue neutral.

The AICPA believes it offers an alternative that is both responsible and effective, and that it merits the very careful consideration of your committee. We stand ready to continue to work with you and your staff in the enactment of this much needed legislation. And we deeply appreciate the assistance we have received from your staff, the staff of Senator Heinz's office, the Joint Committee staff, and others, who have an interest in this solution to a common problem.

Thank you, Mr. Chairman.

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

Our final witness on this panel is Mr. David Kasten, who represents the Farm Credit Council. Mr. Kasten?

[The prepared written statement of Mr. Lerner follows:]

Statement of Herbert J. Lerner

on Behalf of the

American Institute of Certified Public Accountants

Introduction

Mr. Chairman and Members of the Subcommittee, I am Herbert J. Lerner, Chairman of the Federal Taxation Executive Committee, testifying today on behalf of the American Institute of Certified Public Accountants and its nearly 250,000 CPA members. Joining me today is Donald H. Skadden, AICPA Vice President - Taxation. We appreciate the opportunity to present our views on an issue of concern to tax practitioners and small businesses throughout the country.

Mr. Chairman, we are here today to discuss legislation you and your colleague, Senator Heinz, have introduced which, if enacted, would remedy many of the problems and complications created by Section 806 of the Tax Reform Act of 1986. Section 806 mandated that most partnerships, S corporations, and personal service corporations conform their tax years to the tax years of their owners. Section 806 was enacted to address a perceived problem of tax deferral arising from non-conforming years and to raise additional revenues. It will impose a significant burden on small business, on the accounting profession, and on the IRS.

Mr. Skadden and I, along with other members of the AICPA, appreciate the opportunity we have had to work closely with your staff, as well as the staff of the Joint Committee on Taxation, in developing a solution to the problems created by Section 806. We are grateful to you, Mr. Chairman, to Senator Heinz, and to your staffs for the significant effort put forth and for your leadership in supporting a viable solution to this real and serious problem.

Consistent with the political and economic realities at this time, this proposed legislation has been crafted to derive essentially the same amount of revenue from the same group of taxpayers as under the Tax Reform Act of 1986. However, it does so by addressing the issue of tax deferral and tax payments in a unique manner which avoids the administrative problems of shifting most affected taxpayers to the same calendar year end.

A companion bill has been introduced in the House of Representatives by Congressman Ronnie Flippo, who is a CPA and a member of the House Ways and Means Committee. Since the proposal is essentially revenue neutral in relation to the Tax Reform Act of 1986, we suggest that this legislation could appropriately be included in the Technical Correction Act of 1987 (S. 1350 and H.R. 2636).

Let me state at the outset, from a tax policy standpoint, that your legislation was not the AICPA's desired solution to the problem. We would have preferred outright repeal of the year end conformity requirement. However, given the need for a revenue neutral alternative and the belief that tax deferral was a serious problem which should be addressed, in our opinion your legislation is the most viable alternative to the year end conformity requirement.

History of the Year End Conformity Requirement

First, I would like to present some background on the year end conformity requirement and explain how Section 806 became part of the Tax Reform Act of 1986 (H.R. 3838).

The year end conformity requirement was not part of the Treasury Department proposal released in December 1984; it was not part of the President's proposal released in May 1985; and it was not part of H.R. 3838 as passed by the House of Representatives in December 1985. During 1985, the Senate Finance and House Ways and Means Committees held 36 days of hearings on tax reform, and at no time was this provision discussed. A less stringent version of the tax year requirement was added to the Senate Finance Committee package. This Finance Committee version would have continued to allow fiscal years ending in September, October, or November.

An amendment was added on the floor of the Senate during the final hours of debate on tax reform which compounded the problem by mandating the December 31st year end for most partnerships, S corporations, and PSCs.[1] We believe that members of the Senate did not fully understand the many problems this requirement would cause for small business owners, for CPAs, and for the IRS. Section 806 was advanced to keep the Tax Reform Act of 1986 revenue neutral, rather than for sound tax policy reasons.

Impact of the Year End Conformity Requirement on Small Business, the Accounting Profession, and Administration of the Tax System

In the past, sound tax policy permitted the use of fiscal tax years which resulted in staggered tax return filing dates to allow the IRS, taxpayers, and tax practitioners to better meet tax filing requirements. The Tax Reform Act of 1986 failed to recognize that there are many legitimate business reasons for selecting a fiscal year. Fiscal years are ordinarily chosen to coincide with the "natural business year" of an entity, and as a consequence Section 806 will cause tax requirements to interfere with business operations.

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[1] As a practical matter, a fiscal year conformity requirement affects most partnerships, S corporations and PSCs with tax years other than the calendar year, since most of the owners of these closely-held entities are individuals on the calendar tax year.

Section 806 will place an undue burden on the tax system. Taxpayers and return preparers will have difficulty completing the returns of affected entities in sufficient time to allow partners and shareholders to file their individual tax returns by the original due date. This will necessitate costly and inconvenient extensions of time to file returns. Further, it will be difficult to obtain the information necessary to estimate the tax liability of owners in order to apply for an extension without undue risk of penalties. Encouraging the extended filing of tax returns is inconsistent with the efficient operation of our self-assessment system.

Section 806 will impose other costs and administrative burdens on small businesses. Affected entities would be required to close their books twice and file two sets of tax returns (both federal and state) in calendar year 1987 in order to change their tax years. Because Section 806 applies to existing as well as newly formed entities, businesses which have used a fiscal year for many years will now have to amend contracts, compensation arrangements, and retirement and employee benefit plans as a result of this provision.

Section 806 will also create significant workload problems for CPA firms which will be required to compress tax return preparation, financial reporting, and auditing work into a shortened time period. A survey of AICPA Tax Division members revealed that more than 60 percent of their annual workload will now fall in a three-and-a-half month period as a result of the year end requirement. Even if the extension requirements are liberalized, not enough of this work could be spread throughout the year since the accounting and financial reporting needs can not, as a practical matter, be extended much beyond the close of the reporting year.

A further concern is the possibility that, Sections 441 and 442 of the Internal Revenue Code may be interpreted by the IRS to require the financial statement year end to conform to the tax year end for entities subject to Section 806. We understand that the IRS has under consideration the possibility that the financial statement conformity requirement for <u>voluntary</u> year end changes would also apply to <u>mandatory</u> year end changes.

In summary, this requirement of the Tax Reform Act of 1986 will place administrative and financial hardships on small businesses and CPA firms.

<u>AICPA Endorses Baucus-Heinz Legislative Proposal</u>

The AICPA strongly supports your legislative proposal, Mr. Chairman, as it would resolve the fiscal year issue -- on an essentially revenue neutral basis -- without mandating changes in the tax reporting periods of partnerships, S corporations, and PSCs. We suggest that your legislation be incorporated into the Technical Corrections Act of 1987, with an effective date of January 1, 1987.

Your legislation would allow entities which are affected by Section 806 to elect to retain their fiscal years. This optional election would be made at the entity level, not by the individual owners.

Under the provisions of your legislation, owners of electing partnerships and S corporations would be required to make enhanced estimated tax payments determined with reference to the amount of tax deferral based on the entity's preceding fiscal year return. Thus, affected entities could retain the fiscal year that suits their business needs, while making enhanced estimated tax payments in lieu of actual tax payments.

Owners would be required to increase either of the two estimated tax payment safe-harbors (100 percent of prior year's tax or 90 percent of current year's tax) by a percentage of the prior year's deferred income based on the length of the deferral period. The enhanced estimated tax would be calculated at a rate of 35 percent for 1987 and at the highest individual marginal rate in the following years. There is a four-year phase-in of the enhanced estimated tax payments which corresponds to the four-year income spread in the Tax Reform Act of 1986.

For personal service corporations your legislation would postpone the corporate level deduction for salary and other payments to owners if ratable payments have not been made prior to December 31. The safe-harbors for determining whether a deduction is allowed would be based on experience from the prior corporate year, in order to avoid the necessity of predicting income, or actual payments made for the remainder of the current year.

Any entity which is subject to Section 806, and which newly elects or changes its fiscal year, must select a year ending no earlier than September 30. Included in this option are C corporations which elected S corporation status and as a consequence were required to change to a calendar year.

Your legislation also provides a de minimis exclusion whereby taxpayers with aggregate enhanced estimated tax of $200 or less with respect to electing partnerships and S corporations are exempt from this requirement.

It is recognized that retention of fiscal years could create an abusive situation where tiered ownership structures are used. To avoid this, your legislation provides that a partnership, S corporation, or PSC which receives a major part of its gross income from a partnership or S corporation and which has a different tax year from the related entity, is not allowed to retain its fiscal year. This prohibition is not intended to apply to nonabusive situations, such as where the entity has an equity interest in another entity which is not substantial in relation to the owning entity's entire activity.

Your legislation does not provide a tax solution to certain tiered structure situations, such as where a fiscal year PSC owns an interest in a calendar year partnership corresponding to the interest previously owned by the PSC's sole stockholder who is an individual on a calendar tax year. Although we have not developed a solution to this problem, we would support any reasonable proposal which is essentially revenue neutral based on the tax liabilities of the affected class of taxpayers.

It is important to remember that those entities which would be allowed to remain on or to adopt a natural business year under the Tax Reform Act of 1986, could still do so without being subject to the requirements of this legislation. Thus, an entity which is otherwise entitled to use a fiscal year based on a business purpose which satisfies IRS established criteria (including those reflected in Revenue Procedure 87-32 and Revenue Ruling 87-57) will be able to do so without being subject to the requirements of this legislation.

Conclusion

We strongly support your solution to the problems resulting from the year end conformity requirement of the Tax Reform Act of 1986. The AICPA believes it offers an alternative, for those entities which wish to elect it, that is both responsible and effective, and that it merits careful consideration by your Committee. We stand ready to continue to work with you and your staff in the enactment of this much needed correction to the Tax Reform Act of 1986.

Mr. Chairman, this concludes our statement. We will now gladly answer any questions that you or Members of the Subcommittee may have.

STATEMENT OF DAVID KASTEN, 12TH DISTRICT FARM CREDIT BOARD DIRECTOR, TESTIFYING ON BEHALF OF THE FARM CREDIT COUNCIL, BROCKWAY, MT, ACCOMPANIED BY MALCOLM HARDING, PRESIDENT, CENTRAL BANK FOR COOPERATIVES, TESTIFYING ON BEHALF OF THE FARM CREDIT SYSTEM, DENVER, CO

Mr. KASTEN. Mr. Chairman, I will be brief. I do have with me Mr. Malcolm Harding. I would like to add a few moments to the testimony.

My name is Dave Kasten. I am a farmer rancher from Brockway, MT. I own and operate a diversified, small grain and cow/calf operation. I have been a PCA stockholder for 25 years and a Federal Land Bank stockholder for 16 years. I served as the Director of the Glendive PCA for 3½ years. I was elected to the district board of directors by the 12 District PCAs in July of 1985, and am proud to represent the 12th District and the Farm Credit System at this hearing today.

Without the Farm Credit System, I would not have been able to put together a successful operation.

As you know, the agricultural industry is struggling right now in a severely distressed environment. The Farm Credit System that lends only to agriculture is also struggling to absorb losses that go along with a severely distressed agricultural environment. This struggle is getting to the point where Congress is currently considering a financial assistance package to shore up the Farm Credit System. It seems ironic that the Tax Reform Act of 1986 would add approximately $85 million in tax liability to assist them that is grasping for breath.

This added tax will definitely limit the ability of the system to lower interest rates to its farmer/rancher borrowers. One other negative effect the Tax Reform Act has is that it takes away an incentive to build loan loss reserves at a critical point in time when reserves are desparately needed.

Mr. Chairman, I want to express our appreciation to this committee for its efforts to address this problem during the consideration of the 1986 Tax bill. We appreciate that this issue is not at the top of anyone's agenda. When the final decision concerning that monumental piece of legislation was made, we hope and trust that this committee will take the opportunity this year to correct a real inequity that resulted from last minute efforts to achieve agreement on the 1987 Tax Reform legislation.

It is a problem that is very important to the farmer and rancher borrowers of the Farm Credit System, and a problem that we believe can and should be corrected.

Mr. Chairman, I thank you.

[The prepared written statement of Mr. Kasten and a letter to Senator Baucus follows:]

Presented by

David Kasten

District Director of the Twelfth Farm Credit District

Mr. Chairman and members of the subcommittee, my name is Dave Kasten. I am a farmer/rancher from Brockway, Montana, with a small grain and cow/calf operation. I have been a Production Credit Association stockholder for 25 years and a Federal Land Bank stockholder for 16 years. The Farm Credit System helped me get started in farming and develop a sound operation, and I feel an obligation to serve as Chairman of the Board of the Glendive PCA for three and a half years. I was elected to the district board of directors by the Twelfth District PCAs in 1985, and it is my pleasure to represent the Twelfth District and the Farm Credit System at this hearing today.

As a district director I am involved monthly in reviewing the financial condition of each Twelfth District Bank and our Federal Land Bank Association and PCA. Thus, I believe I am well qualified to testify as to the adverse impact on the PCAs and Banks for Cooperatives resulting from the Tax Reform Act of 1986. As you know, the Tax Reform Act of 1986 repealed the provision of the Internal Code (the Code) that permitted Farm Credit System institutions to utilize the reserve method of accounting for loan losses for tax purposes. Beginning in 1987, System institutions are permitted to claim bad debt deductions only when specific loan losses are realized. In addition, as part of the transition from the reserve method of accounting for bad debts to the specific charge-off method, System institutions will be required to "recapture" their existing loss reserves as income over a four-year period. This will result in increased federal income taxes during the very period when many System institutions are struggling to survive. We do not think it makes any sense from a public policy standpoint to penalize System institutions through changes to the Tax Code at a time when Federal financial assistance is required to ensure the survival of this essential credit delivery system for American agriculture.

However, even if we consider this matter strictly from the standpoint of fairness and equity in the tax system, we believe that there is a compelling argument for correcting the action taken in the Tax Reform Act of 1986 with respect to the System' bad debt reserve deductions. As you will recall, in early 1986 the System brought to the attention of the Senate Finance Committee what we believed to be a major inequity in the tax reform proposal passed by the House of Representatives. The House bill repealed the use of the reserve method for taxpayers generally (including System institutions), but would have essentially preserved the use of the reserve method for small commercial banks and thrift institutions. The System pointed out that there is no sound justification for the disparity of tax treatment between taxable System institutions and small commercial banks (which are our principal competitors) and that this disparity results solely from the fact that neither PCAs nor BCs are technically treated as banks for Federal income tax purposes because they are not authorized to accept deposits.

This Committee and the Full Senate responded to our plea by explicitly preserving the reserve method for taxable System institutions in the Senate's tax reform bill. Quite frankly, we thought that the action of the Senate merely corrected an oversight in the House bill and that we would not be in jeopardy when the tax reform bill went to conference. We were right up until the very end of the conference when in the complicated final compromise agreement apparently there was a decision made to drop this provision of the Senate bill. I say "apparent decision" because the language of the summary of the conference agreement was ambiguous on this issue. It was only after many days had elapsed that we were apprised by the staff that this provision of the

Senate bill had in fact been dropped. We have yet to receive a satisfactory explanation of the factors that led to this decision.

Morever, the inequity of which we had complained had in fact become more glaring with the conference agreement because the final tax reform bill recognized the need to defer implementation of the repeal of the reserve method for large troubled banks. Somehow or other, the System seemed to get lost in the larger controversy surrounding the treatment of commercial banks and thrift institutions.

I recount this brief tax history solely to renew our basic contention that System institutions were treated unfairly in the 1986 Tax Reform Bill. System institutions are in fact financial institutions that face the same types of problems as commercial banks. Even though System institutions raise their funds through the public sale of debt securities rather than through the acceptance of deposits there is no basis, in our view, for the disparate tax treatment of their bad debt losses. Certainly System institutions are at least as threatened by loan losses as their commercial bank counterparts. Indeed, because System institutions are authorized only to extend credit to the agricultural sector and thus cannot diversify their loan portfolios, a strong argument can be made that they should have even more tax incentives than commercial banks to build adequate reserves. At a minimum, they should not be penalized.

Again Mr. Chairman, I want to express our appreciation to this Committee for its efforts to address this problem during the consideration of the 1986 tax bill. We appreciate that this issue was not at the top of anyone's agenda when the final decisions concerning that monumental piece of legislation were made. We hope and trust that this Committee will take the opportunity this year to correct a real inequity that resulted from the last minute efforts to achieve agreement on the 1986 tax reform legislation. It is a problem that is very important to the farmer/rancher borrowers of the Farm Credit System and one that we believe can and should be corrected.

THE FARM CREDIT COUNCIL

50 F STREET, NW • SUITE 900 • WASHINGTON, DC 20001 • 202/393-3744

July 24, 1987

Honorable Max Baucus, Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
SD-205 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman:

We appreciate the opportunity to supplement our prepared and oral testimony with respect to the issue you raised at the hearing on Wednesday. You asked what the Farm Credit System's response is to those who contend that System institutions should not be treated comparably to commercial banks because they do not accept deposits. As indicated below, we believe that the issue of deposit authority is basically irrelevant to tax treatment of the System's bad debt losses. Moreover, we believe that there are basic distinctions between System institutions and other finance companies that were similarly denied use of the reserve method of accounting for bad debts under the Tax Reform Act of 1986. Clearly, System institutions are more comparable to commercial banks than they are to finance companies and they should be taxed accordingly.

First, System institutions and commercial banks in rural areas serve the same basic function in that they both obtain funds from the public and make those funds available to creditworthy borrowers. Congress decided that System institutions should raise their funds by issuing debt securities through the public debt markets. This decision is consistent with Congress' conclusion that commercial banks cannot fully satisfy the credit needs of rural America. The relevant point is that System debt securities are functionally equivalent to deposits taken by commercial banks. The different manner in which System institutions and commercial banks obtain funds from the public simply does not warrant different tax treatment of their bad debt reserves.

Second, a related question is why System institutions should be treated like commercial banks while other finance companies (which also raise their funds through the issuance of debt securities rather the taking of deposits) are denied use of the reserve method of accounting for bad debts. We believe that there are sound reasons for distinguishing between System

Honorable Max Baucus, Chairman
July 24,1987
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institutions and other finance companies in this regard. System institutions, unlike other finance companies, are federally chartered and regulated financial institutions created to serve a limited, but vital, banking function for rural America. Unlike commercial finance companies that voluntarily elect to pursue particular lending opportunities that they find attractive, System institutions operate under a Federal mandate to make credit available to all eligible farmer and cooperative borrowers in good times and bad.

Third, the Farm Credit System was created and nurtured by the Congress which, at this very time, is considering major legislation to ensure its survival. The question being asked by the farmer/owners of the System is why, at a time when System resources are nearly depleted and Federal funds may be required to maintain the System, should the Congress adopt tax provisions that treat the System more harshly than commercial banks and place a greater burden on System institutions. Does this make any sense from either a tax or public policy standpoint? We think not.

Finally, we would like to amplify for the record the reasons why we believe that the System should be viewed as a single entity in determining whether individual System institutions qualify for the "troubled bank" provisions of section 585(c). As everyone on this Committee is aware, the System has incurred extraordinary losses as a consequence of the difficulties that have befallen the agricultural sector. These losses have affected, either directly or indirectly, all System institutions because all System institutions are inextricably bound together through numerous statutory and contractual ties. For example, all System banks are jointly and severally liable on System-wide debt obligations issued to the public. The associations (i.e. production credit associations or PCAs), in turn, are directly affected by the financial condition of the bank in their district because that bank is their sole source of funds.

Accordingly, if this Committee decides to treat System institutions in a manner comparable to commercial banks, we urge that, in determining whether a large System institution should be treated as a "troubled bank", the test should be applied to the System as a whole rather than to individual units of the System. More specifically, we propose that in computing the "nonperforming loan percentage" under section 585(c) of the Code that the computation be made with respect to the combined statement of condition of the Farm Credit System. The sentence that we would propose adding to section 585(c)(3)(B)(iv) to accomplish this result is set forth below:

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> In the case of a bank which is an institution of the Farm Credit System, the "nonperforming loan percentage" of such bank shall be the percentage calculated with respect to the combined statement of condition of the Farm Credit System.

A copy of the System's most recent annual financial statement, which clearly documents the magnitude of its nonperforming assets relative to its equity, is attached.

Again, we appreciate this opportunity to provide additional material for consideration by your committee.

Yours very truly,

John A. Waits

John A. Waits
President

Senator BAUCUS. Thank you, Mr. Kasten.

Mr. Ambassador, as I understand it, what you are saying is that nonfiction, the expenses devoted to determining which nonfiction—math or science textbooks, for example—are appropriate for school districts should be deducted currently because it is an expense; really, it is in the nature of a research and development expense, and that your industry—that is, publishers—should be entitled to that expense because it, in fact, is R&D expense.

Ambassador VELIOTES. Yes, sir.

Mr. Chairman, we recognize that not all so-called pre-publication expenses would be eligible for deduction under section 174. But we do have legitimate R&D expenses which we believe should be deductible.

Senator BAUCUS. So you want to limit them to what, what expenses? Not all pre-publications. What pre-publication expenses do you think should be entitled to a current deduction?

Ambassador VELIOTES. Well let me first say what types of expenses we would not contemplate including. This would be the preparation of plates, authors' advances, proofreading and copy editing. These would be capitalized. The kinds of expenses that we would seek to deduct under 174 would be those that are concerned with the development of the product, the conceptualization of the product, the creation of a prototype, the testing of the product, the feedback, the revision. We have sought to define the R&D category of expenses to be deducted to the extent possible along the lines of hard R&D, and we are in this context in consultation with the Treasury.

Senator BAUCUS. Mr. Massie, how many books do you think earn income, that is, to cover expenses? How many books that authors write and they are published do——

Mr. MASSIE. Earn out their advances?

Senator BAUCUS. Yes.

Mr. MASSIE. Less than half.

Senator BAUCUS. Now is there a trend? Are there fewer and fewer as years go by or is there more?

Mr. MASSIE. Actually, Mr. Veliotes could probably answer that question better than I since he represents the publishers.

The average writer in this country—that is, the median income of writers in this country—as I said, is very low. The problem is that the public, when they read about writers, it is generally in connection with a unique, very large advance. So people think that writers are rich. They are not. Because of this, we have had a great, many, about 5 or 600 letters come into the Authors Guild from people who are worried. Most of them are people who are making $10,000 or $12,000 a year from writing. They cannot deduct their expenses from writing these books, so they have to drop it. They may have other incomes. They may be teachers. They may be doing other things. But all of the—to answer your question specifically—all of the poetry, all of the adventuresome, imaginative, new writing, young writers, beginning writers, are going to be, discouraged. It is going to be very, very difficult for them to go ahead if they cannot deduct their expenses currently. The income forecasting requirement is really going to be impossible.

I could bring a hundred writers in here of all different income levels and they would all tell you the same thing.

Senator BAUCUS. And I take it that is different than the tax laws that apply to other creators, as other artists. What about the painters, the sculptors, those expenses? Are those deducted currently?

Mr. MASSIE. I don't know. I know that I can speak generally for playwrights, screenwriters, song writers, people who write. I don't know about people who create in other forms. We have all been deducting our expenses currently. We have had a tax case, as you are perhaps aware, in the Second Circuit, which the IRS had insisted that we capitalize under the previous tax bill. The Second Circuit Court, after a very long exhaustive case, decided that that was not the intention of Congress, and that Congress had been wise in its previous law not to require capitalization because it would be impossible. This was in May. And at the very moment when we were about to celebrate the victory in this complicated, lengthy and expensive court case, we learned, that the 1986 tax law may have reimposed the same obligation, which is why we are here today.

Senator BAUCUS. Mr. Lerner, you heard the testimony of Secretary Chapoton who is concerned about enforcements and also concerned about the potential revenue effect of your efforts. Do you have any reactions or comments in response to his concerns?

Mr. LERNER. Yes; first, on the question of complexity, it is always difficult to develop unique solutions to problems, and when you are constrained with an attempt to secure an essentially revenue neutral solution, you are necessarily going to have slightly complex language. But I think it is only statutory language that is complex. The implementation I don't think is complex because the owner of an interest in an affected partnership or S corporation will receive a one-line item that indicates to him or her what the required enhanced estimated payment will be for a given year, and that will become a one-line item on a 1040 estimated tax return.

Senator BAUCUS. Does your profession believe that with the changes there still would not be a problem with enforcement, that is, taxpayers would still be forced to comply with the law?

Mr. LERNER. Oh, yes. We think that is so.

Senator BAUCUS. And what about the revenue problems that the Secretary mentioned?

Mr. LERNER. What we have heard in terms of the revenue estimate is that the proposal is essentially revenue neutral. And since what we are trying to do is advance estimated tax payments in lieu of actual payments, I am not sure I understand the reason for the problem from his perspective. I do understand that there is a slight revenue loss, but I cannot tell you the amount of that. We were dealing with a $1.7 billion overall problem, and I think the largest portion of that is recouped through estimated tax payments.

Senator BAUCUS. Thank you. Senator Bradley?

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

Let me thank the panel for their testimony. I think that you have raised a number of problems, some of which we would like to try to address in the Technical Corrections bill.

Let me say I particularly appreciate the testimony of Mr. Massie because, frankly, as far as I am concerned Congress never intended to apply the uniform capitalization rules to the research and writing expenses of authors. The reverse was the case, Mr. Massie. I thought it was very clear that we intended that the cost be a deductible item under Section 162. And so wherever the footnote came from, and whatever its intent was, I certainly do not think that it should apply to authors.

The uniform capitalization rule applies only to tangible property. It is fairly difficult, I would think, to try to make the case that a poem is a tangible piece of property. I mean, a piece of paper might be, but a poem is an idea, and I cannot conceive of how one could construe it to be tangible property. That is my own reading of your dilemma. I am sorry that I cannot give a fuller explanation as to where the footnote came from. I can only assert that my reading of it is that it is flawed, inconsistent, and it certainly is contrary to the intent of Congress.

The other witnesses have offered, I think, interesting and important testimony as well. And the real question will be in the context of the Technical Corrections bill what can we try to deal with and what do we have to forego for another time. But I thank the panel very much for their testimony.

Senator BAUCUS. Thank you, Senator Bradley.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

I have had the opportunity to talk with Ambassador Veliotes previously about the problems the publishers run into in connection with their 174 on the R&D, and I will look at the testimony from the other witnesses. Each of these witnesses has presented some serious problems, and certainly we are going to do the best we can to address them.

This is a complicated area, to state it mildly. But in everything we do affects revenue. But, nonetheless, I think each of these are serious problems.

I am a cosponsor of legislation to correct the problems raised by Mr. Silver and by Mr. Lerner, so we will all be working together to see if we can't solve these problems you gentlemen have brought up.

Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator Chafee.

A question for Mr. Massie from Senator Moynihan. And he unavoidably is not here. He is chairing a hearing at another committee.

Senator CHAFEE. Yes. I just came from that hearing. He is chairing an infrastructure hearing upstairs with the Public Works Committee.

Senator BAUCUS. His question is: If writers are subject to the uniform capitalization rules, and the work does not produce income, when will the expenses for that work be deductible?

Mr. MASSIE. None of us has gone through an audit, based on this, because it starts in 1987. According to our rule, they will never be deductible. If there is no income in a year, we will lose the expenses that we incur in that year on that project. One of the problems is that we are going to have to—most writers have several projects in hand at a time. We are going to have to divide up income and expenses and allocate them to these different things, down to reductio ad absurdum to a third of a typewriter ribbon, a third of a bottle of whiteout, and so forth. But in the years in which there is no income, as we understand it and as it has been explained to us by Treasury, we will have no deduction.

Senator BAUCUS. And he has a similar question, and that is, does the deduction require abandonment of the copyrights for unstopable work?

Mr. MASSIE. That is what we understand. In order to try and claim those expenses as a loss, we will have to abandon a copyright, which is a crippling thing to do to a writer. Something which may not produce income now should not be taken from the writer because it belongs to him like a child. And in the future he may be able to do something and to breathe new life into it. He should not have to lose his copyright in order to claim a loss deduction.

Senator BAUCUS. A question for Mr. Silver is: Where did 67(c) come from?

Mr. SILVER. Senator, that is a mystery. As I said, there were no hearings. There was no debate. It appeared in the middle of literally 60 or 70 pages of technical amendments. I happened to be in Jerusalem when a member of my staff plowing very diligently through those 60 or 70 pages called me, told me about it, and I have to say the expletive must be deleted from my response.

As far as we can determine, if you recall the history of the 212 personal miscellaneous deduction matter in the Senate bill, such deductions were going to be eliminated. There was no floor, there was just a total elimination of the ability to deduct these expenses. There may have been some concern that wealthy taxpayers could create some business medium, perhaps an investment company or perhaps some other business medium, and in effect deduct the personal expenses of managing their money through this kind of investment intermediary. Probably that was the genesis.

Of course, two things happened. One is that there is now a 2-percent floor on personal miscellaneous deductions, and certainly wealthy taxpayers who have hefty personal deductions in managing their own money will exceed that 2-percent floor. So that concern actually became meaningless the day the bill was enacted.

In any event, if there is any residual concern about this occurring, the bill which you have cosponsored with 14 of your colleagues on the committee does give the Treasury ample authority to prevent any abuse.

Certainly the section was never intended to hit somebody who has $8,653 of gross income outside of Social Security.

Senator BAUCUS. Thank you very much.

Mr. Kasten, you are basically saying that the Farm Credit System banks should get the same bad debt reserve treatment as banks. Is that essentially what you are saying?

Mr. KASTEN. That is correct.

Senator BAUCUS. Now what do you say to those on the other side, the other body—that is, the House of Representatives—who, when this issue came up before us, say the farm credit system institutions are really on the nature of financial institutions who are not entitled to the same bad debt reserve reduction rather than banks. That is, it is Farm Credit System institutions are closer to finance institutions than they are to banks. What can you tell us so that we can go back over to the House and convince them that no, that you are more in the nature of banks and are entitled to the same reserve deduction?

Mr. KASTEN. Well we, Mr. Chairman, would like to be treated on the same basis as the commercial banks. And I think it was just a technical grit that that went by at that point. I don't think it was the intention.

Senator BAUCUS. Well I appreciate that. And I think particularly given the adverse plight of the Farm Credit System today that that argument will carry much more weight than it did last year.

I appreciate your testimony and that of other witnesses. We have no more questions. And thank you all very much for coming.

STATEMENT OF MORTIMER CAPLIN, COUNSEL, CAPLIN & DRYSDALE

Mr. CAPLIN. Mr. Chairman, my name is Mortimer Caplin. If you would permit me, I would like to answer Senator Bradley's question as to where this famous footnote came from dealing with so-called creativity side of either producing a book under the author's standpoint or from the publisher's.

This statute, 263(a) is aimed at tangible property, tangible. Intangible property is not supposed to be covered. And yet we are talking about intangibles in the footnote. But we haven't been able to find a Senator or a Member of the House of Representatives who really has any idea where this came from. I think it was written by an alchelmist who really wanted to make tangible something that was truly——

Senator BAUCUS. Well it sounds like it was written by somebody who wanted to provide plausible deniability. [Laughter.]

Mr. CAPLIN. I agree with that completely, Mr. Chairman.

Senator BAUCUS. Thank you all very much. We appreciate it.

Our next panel will consist of Mr. Larry Simons, who is representing the Council of State Housing Agencies; Mr. Conrad Teitell, testifying on behalf of the Committee on Gift Annuities; Dr. Michael Malone from Montana State University; the Honorable Kevin Blanchette from the State of Massachusetts; and Mr. Kenneth J. Kies, testifying on behalf of the Section 457 Task Force.

Gentlemen, thank you very much for appearing. Again, I will ask each of you to conform to the 3-minute rule. When we get to the question period, perhaps it could be a little longer, but let's for the time being keep it at three minutes. And we will begin with Mr. Simons who is always front and center.

STATEMENT OF LAWRENCE B. SIMONS, REPRESENTATIVE, COUNCIL OF STATE HOUSING AGENCIES, WASHINGTON, DC

Mr. SIMONS. Thank you, Mr. Chairman. My name is Lawrence B. Simons and I am pleased to appear before you on behalf of the Council of State Housing Agencies to address certain provisions of the proposed Technical Corrections Act, specifically as they relate to the low income housing tax credit.

The Council of State Housing Agencies represents housing finance and credit agencies in all 50 States, plus the District of Columbia, Puerto Rico and the Virgin Islands. These agencies have been charged with the administration of the tax credit program.

In appearing before you this morning, Mr. Chairman, I am also expressing the views of an additional 11 organizations, including the National Association of Home Builders, the Interprise Foundation and the National Low Income Housing Coalition, which have written to the Finance Committee with respect to the technical corrections legislation.

I would request your permission to insert in the record the communication of the 12 organizations to Chairman Bentsen, together with a more detailed comments on S. 1350.

I would like to begin by expressing the gratitude of the housing community to the Finance Committee for the very important improvements which the Technical Corrections bill would make in the low income housing tax credit statute.

As you know, in the tax credit provisions of the 1986 Reform Act, the Congress made a virtually complete break with the history of federal tax incentives for rental housing in general and low income housing in particular. It did so without one day of hearings on the tax credit proposal and with little opportunity for extended discussion among the members. And in light of the way in which the tax credit proposal was enacted, it is not surprising that it contained a great many serious technical flaws.

S. 1350, combined with various clarifications in the "Blue Book", would go a very long way to correcting these problems. The purpose of my written testimony is to identify those few areas in which S. 1350 does not provide an adequate remedy. And I hope my oral testimony today will be confined to the critcal problem not adequately address in S. 1350.

Predictability and certainty of the essence of the development of low income housing, accordingly a most needed change in S. 1350, involves modification of the prohibition on carryover of a credit allocation from one year to the next. Under current law, a project must be placed in service in the specific year with respect to which it has been granted a credit allocation. If it is not completed and in service by the end of that year, the credit allocation, an allocation which was most likely made two years earlier, is lost, both to the project and the State which had provided it.

Mr. Chairman, this is a totally unworkable requirement. After more than 20 years as a builder and having served as Assistant Secretary for Housing for 4 years, I can assure you that the completion date contemplated at the inception of a multifamily housing project is, at the very best, an optimistic guess, and a guess which can easily be off by 12 months or more.

Whether the results of contractor problems in New York, unpredictable weather in Montana, environmental litigation in California or permitting problems in Illinois, multifamily construction is very vulnerable to many, many delays.

Because of this, when I was responsible for the administration of all HUD housing programs, we never had a mandatory completion date for our projects. We required developers to commence construction within 12 months or 24 months, depending on the program, in order to assure that the commitments were actually used. But we never had a completion date because we knew that, first, developers had every incentive to complete projects as quickly as they could, and, second, that the completion dates are unpredictable.

Congress has followed this pattern of using completion dates in its various housing bills, for instance, the HODAG program and the 3-year period for the use of bonds under the tax exempt bond provisions. None of them use a completion date. And we urge you, Mr. Chairman, to look at this very carefully because without the certainty that the start gives and the commitment being tied up at the start, no lender will be able to commit to that project in a fine way. To have it subject to the way it is now proposed, the possibility of the Treasury has to rule on whether or not the delay complies with the statutory provision is absolutely unworkable. The predictability, the constancy which a lender needs is not there if some condition subsequent can take away what would be the vital commitment for the equity in the project.

Thank you very much.

Senator BAUCUS. Thank you, Mr. Simons.

Mr. Teitell, is that a correct pronunciation of your name?

Mr. TEITELL. Yes, it is, sir. Thank you.

[The prepared written statement of Mr. Simons follows:]

THE COUNCIL OF STATE HOUSING AGENCIES

Mr. Chairman, members of the Subcommittee, my name is Lawrence B. Simons, and I am pleased to appear before you on behalf of the Council of State Housing Agencies to address certain provisions of the proposed Technical Corrections Act of 1987 (S.1350), as they relate to the low income housing tax credit. The Council of State Housing Agencies represents housing finance and credit agencies in all fifty States plus the District of Columbia, Puerto Rico and the Virgin Islands. These agencies have been charged with administration of the tax credit program. In appearing before you this morning, Mr. Chairman, I am also expressing the views of an additional eleven organizations, ranging from the National Association of Home Builders to the National Low Income Housing Coalition, which have written to the Finance Committee with respect to the Technical Corrections legislation. I would request your permission to insert in the record the communication of the twelve organizations to Chairman Bentsen, together with their more detailed comments on S.1350.

I would like to begin by expressing the gratitude of the housing community to the Finance Committee for the very important improvements which the Technical Corrections bill would make in the low income housing tax credit statute. As you know, in the tax credit provisions of the 1986 Tax Reform Act, the Congress made a virtually complete break with the history of federal tax incentives for rental housing in general, and low income housing in particular. It did so without one day of hearings on the tax credit proposal and with little opportunity for extended discussion among the members. In light of the way in which the tax credit proposal was enacted, it is not surprising that it contained a great many serious technical flaws. S.1350, combined with various clarifications of Congressional intent which were expressed in the General Explanation of the Tax Reform Act of 1986 (the "Blue Book"), would go a very long way to correcting these problems. The purpose of my testimony this morning is to identify those few areas in which S.1350 does not provide an adequate remedy.

The most needed change involves modification of the prohibition on carryover of a credit allocation from one year to the next. Under current law, a project must be placed in service in the specific year with respect to which it has been granted a credit allocation. If it is not completed and in service by the end of that year, the credit allocation is lost -- both to the project and to the State which provided it.

Mr. Chairman, this is a totally unworkable requirement. After more than twenty years as a builder, I can assure you that the completion date on a multifamily project is, at the very best, an optimistic guess, a guess that can easily be off by twelve months or more. Whether the results of contractor problems in New York, unpredictable weather in Montana, environmental litigation in California or permitting problems in Illinois, multifamily construction is very vulnerable to delays. Because of this, when I was responsible for the administration of all HUD housing programs, we <u>never</u> had a mandatory completion date for our projects. We required developers to <u>commence</u> construction within twelve months or twenty-four months, depending upon the program, in order to assure that commitments would actually be used. But we never had a completion date, because we knew that, first, developers had every incentive to complete the projects as quickly as they could, and second, that completion dates are unpredictable. I would add that we routinely extended the dates by which construction had to be commenced, if the developer demonstrated a reason for such a delay.

Mr. Chairman, no developer will commence construction -- or even obtain financing -- in reliance upon the tax credit if he knows that a delay of any sort will cause the loss of that critical incentive. The effect is particularly severe on the more ambitious projects which involve combinations of assistance, development in troubled neighborhoods, extensive community involvement and so on. These projects require a long lead time in order to get the various pieces into place, and require constant adaptation as construction proceeds. These are precisely the kinds of projects that we ought to be encouraging with the tax credit. These are precisely the kinds of projects that the no-carryover rule will eliminate. In addition, by forcing developers to rush to meet a completion date, the statute can increase both construction costs and hazards.

Acknowledging this problem, the drafters of the Technical Corrections bill provided, in Section 102(l)(17), that a credit allocation could be carried over to the succeeding taxable year if the initially projected completion date was reasonable and the delay was caused solely by unforeseen conditions which were not within control of the taxpayer. Unfortunately, this rule is simply inadequate. A developer cannot afford to risk his investment on the hope that, should a delay occur, a Treasury Department official will, after the fact, determine, first, that the initially projected completion date was "reasonable", second that the delay was caused "solely" by unforeseen circumstances, and third that those unforeseen circumstances were beyond the developer's control.

The housing groups propose a simpler, more workable standard than that contained in the bill. Carryover should be permitted where at least half the cost of a project has been incurred by the end of the allocation year, and where the project is placed in service in the following year. I would add, Mr. Chairman, that in my judgment even this rule is unnecessarily stringent. Congress already has a perfectly good carryover rule in the tax exempt bond provisions, permitting bond authority to be carried over for three years if it has been allocated for a specific purpose or to a specific project. The same principle can easily be applied to the tax credit. If an allocating agency commits funds to a specific project by the end of the allocation year, the project should have three years to come into service.

Note that this rule is still more stringent than the bond rule, since under the bond rule one need only issue bonds for a project, whereas under the credit carryover proposal, one would have to complete construction. Still, I believe a three-year time period following a commitment of credit authority is consistent with general industry practice and would be workable.

Permitting carryover of bond allocations might well produce a savings to the Federal Government. While it has been claimed that the absence of a carryover rule would result in the loss of credit allocation for most states, I submit that the more likely occurrence is that as a year winds down, allocating agencies will look around for projects that are just going into service or have already gone into service to allocate credit to. As a result, the credit allocations will be used, but they will be used on existing projects which were developed without any intention of using the tax credit and which are already in service. On the other hand, if carryover is permitted, allocations will go to projects that are specifically dependent upon the credit, projects that will not go into service for several years. Accordingly, revenues will be saved.

A second matter which I would like to bring to your attention concerns the most significant housing problem confronting the Federal Government today -- the preservation of the existing supply of assisted housing. With restrictions expiring on hundreds of thousands of units of assisted housing built in the mid-1960s and early 1970s, the Banking Committees have made their top priority the retention of this stock for lower income use. Ironically, this is the one area in which the technical corrections legislation, as introduced, would take a step backwards.

The tax credit statute currently denies credit on the acquisition cost of an existing project if the project has changed hands within the preceding ten years. Treasury may waive this restriction for certain federally-assisted projects (i) in order to avoid an assignment of the mortgage to HUD or FmHA, (ii) to avoid a claim against a federal mortgage insurance fund or (iii) "by reason of other circumstances of financial distress." This last category was interpreted by the housing community to permit waivers in the case of federally-assisted projects which were not insured by HUD, but which were financed by state agencies. Section 102(1)(7) of S.1350 would strike this last clause, thereby eliminating approximately half of the assisted housing projects -- representing perhaps 400,000 units -- which might otherwise be eligible for the waiver.

This provision moves precisely in the wrong direction. The Congress ought to be working to expand the use of the credit with the inventory of federally-assisted housing. Housing groups have proposed an amendment which would permit the tax credit to be used for all distressed projects, which are either federally-assisted, federally-financed or federally-insured. The entire inventory of federally-related housing should be viewed as a present or potential resource for lower income people and a prime target for use of the credit.

There is no cost to this amendment, since any use of the credit proposal with such projects would have to come within the currently existing state caps. In addition, there is no likelihood for churning or abuse, since the credit can only be used with projects that the applicable federal or state agency has determined to be in financial distress or in danger of being converted to non-low income use.

A third area deserving of particular attention involves the current inability to use the credit in the nation's poorest areas. The limits for lower income tenants in the program are 50% or 60% of the area median income, depending on whether the "20-50 test" or "40-60 test" is used. Rents are restricted to 30% of the applicable income ceiling. In the poorest areas of the country, these restrictions combine to produce permissible rents so low as to make it impossible to support construction. Rural housing groups have determined that, even combined with Farmers Home Administration subsidies which lower interest rates to 1%, the tax credit income restrictions make the program unworkable in 68 out of 75 counties in Arkansas, 54 out of 101 counties in Kansas, 19 out or 20 counties in Maine, 44 out of 87 counties in Minnesota, and so on. In dollar terms, the income limits mean that in 14 counties in Mississippi where median incomes are $16,000 or below, the maximum rent you can charge for an apartment unit is $240.00, less a utility allowance. In 38 Texas counties, with incomes of $20,000 or below -- compared to a $28,000 State median -- the maximum rent you can charge is $300.00, less utilities. Mr. Chairman, you cannot build even subsidized housing at these rents.

We propose that, as the law currently allows with regard to mortgage bonds, allocating agencies be permitted to use the higher of the state median income or the county median income. This rule will cost nothing, but it will open up the tax credit program in the neediest counties in this nation.

The other improvements which we seek in S.1350 are more technical in nature. First, we are seeking clarification that federal or state rental assistance is not to be counted as a tenant payment for purposes of the so-called "deep rent skewing" provisions. Under these provisions, special treatment is provided for projects in which market rate rents are at least 3 times the rents charged to lower income households, and at least 15% of the lower income units are allocated to households at 40% of the area median income or below.

S.1350 provides that, consistent with the rest of the credit law, rental assistance payments are to be disregarded for purposes of determining the maximum rent paid by low income tenants. It provides, however, that those assistance payments are to be counted for purposes of determining the 3-to-1 ratio between market rents and low income rents. Beyond its inconsistency, this provision effectively makes the deep rent skewing provision unworkable in the single context in which might otherwise have some value -- that is, a partially assisted, subsidized project in a high-cost area. In my judgment, this is the only circumstance in which any owner would have an incentive to elect deep rent skewing treatment, and yet the inconsistent and irrational treatment provided by S.1350 would make deep rent skewing unusable. Rental assistance payments should not be counted as tenant rent payments -- since they are not tenant rent payments -- for all purposes under the tax credit, including the 3-to-1 ratio under deep rent skewing.

In another matter, I would note that perhaps the first "technical amendment" to the credit statute was contained in the 1986 budget reconciliation bill. This amendment eliminated a provision that would have effectively denied the tax credit to projects which received more than 80% non-recourse financing. This provision, a carryover from the at-risk rules applicable to tax credits in areas other than real estate, simply ignored the fact that low income housing is absolutely dependent upon non-recourse mortgage financing. When the provision was discovered, Congress acted quickly to eliminate it. In the effort to deal with the 80% provision, however, a more obscure requirement of the at-risk rules was overlooked. This requirement effectively excludes even bona fide non-recourse financing from the tax credit base, if the property was acquired from a related person. Since most development and syndication transactions involve some level of dealing among related parties, this constitutes a significant obstacle. It should be eliminated. I would stress, Mr. Chairman, that we believe this provision to have been an oversight in the initial statute, and since there are a number of rules in the tax code which already address related party transactions directly, there is no need to provide this "back-door" restriction through the at-risk rules.

Another proposed technical amendment would clarify that the so-called "35 partner election", which enables a partnership to avoid tax credit recapture so long as the project continues to comply with low-income requirements, applies to two-tiered partnerships. Under such arrangements, there are only two partners in the partnership which actually owns the property -- a general partner and an investor limited partnership. The second tier -- the investor limited partnership -- will have 35 or more members. This is the way in which HUD normally requires partnerships to be structured for the ownership of assisted housing. The statute should make clear that such a partnership would qualify under the 35 partner rule.

We are also seeking clarification on the definition of "eligible basis." Specifically, the statute provides that the eligible basis of a building is determined on the date such building is placed in service. This definition leaves unclear the status of routine "build-out" expenditures incurred after the in-service date. The bill should specify that the eligible basis of the building is determined at the time that the building's qualified basis is determined, which would be either the last day of the taxable year in which the building is placed in service or the last day of the succeeding tax year.

In conclusion, Mr. Chairman, I would note that while the combination of amendments already in S.1350 and those which we are seeking would remove serious technical obstacles to the use of the credit, it is a long way from being the efficient tax incentive which is needed for lower income housing. The most serious substantive problem is the passive loss rule, which, as it applies to tax credit projects, effectively eliminates what had been the primary market for low income housing investments -- "accredited investors." As a result, tax credit projects must be sold either through large public syndications or to an entirely new corporate market. This creates enormous inefficiency through high transactional costs and a lengthy educational process. In short, the passive loss rules mean that the taxpayer is getting very little in return for the substantial subsidy dollars being put into the low income tax credit.

I would hope that the Finance Committee, in the near future, will take a more detailed look at the tax credit and address this problem, as well as a number of other significant substantive questions. These include the penalties on using tax credits with other federal subsidy programs, the inability on the part of state agencies to increase the credit percentage for worthy projects, and the burdens placed on a project when tenants go over-income.

Mr. Chairman, I am grateful for your concern and look forward to the Finance Committee's Technical Corrections Bill. Thank you very much.

STATEMENT OF CONRAD TEITELL, PRERAU & TEITELL, TESTIFYING ON BEHALF OF THE COMMITTEE ON GIFT ANNUITIES, WHITE PLAINS, NY ACCOMPANIED BY FLOYD K. HOOPER, NATIONAL TREASURER, THE SALVATION ARMY, AND TAL ROBERTS, EXECUTIVE VICE PRESIDENT, BAPTIST FOUNDATION OF TEXAS

Mr. TEITELL. I am Conrad Teitell. I am a lawyer. I am here today on behalf of the Committee on Gift Annuities, the National Association for Hospital Development, and the Council for the Advancement and Support of Education. These three coalition groups represent thousands of educational, hospitals and religious and other charitable organizations that are exempt under Section 501(c)(3) of the Code.

With me today is Tal Roberts. He is Executive Vice President of the Baptist Foundation of Texas and Vice Chairman of the Committee on Gift Annuities. And also here today is Colonel Floyd K. Hooper, the National Treasurer of the Salvation Army and a member of the Committee on Gift Annuities. We thought we would give plausible credibility to our testimony by coming with a Colonel in uniform.

Senator BAUCUS. Careful. [Laugther.]

Mr. TEITELL. Suppose that you want an annuity, sir, that will pay you $850 a year for life. You can get that annuity by paying $6,000 to X. Y wants $10,000 for the same annuity. You are going to deal with X. Correct? Why pay $10,000 for an annuity when you can get the same thing for $6,000?

Now let me identify X and Y. X is a commercial insurance company. Y is the Salvation Army or another worthy charity. The charity's annuity is called a charitable gift annuity. You are only going to get the gift annuity from the charity if you want to make a charitable gift.

Code section 501(m), enacted by the Tax Reform Act last year, taxes charitable organizations on income earned by providing "commercial-type insurance." Charitable gift annuities issued by the Salvation Army and thousands of other charities are not commerical insurance. A donor who receives payments under a gift annunity is not motivated to maximize his or her return but rather to make a charitable gift. And these charitable gift annuities have been used for over 100 years as an important way for charities to get modest gifts from individuals who otherwise could not afford to make charitable gifts until death.

Charitable organizations that provide gift annuities do not compete with life insurance companies that sell commercial annuities. Indeed, the person who makes the gift annuity isn't in the market for a commercial annuity. Rather, the donor who wants to make a charitable gift and has selected a gift annuity as the method, had the donor not made the gift to the charity, he or she would not have purchased a commercial annuity.

There is a section of the Code, 514(c)(5), enacted by the Congress back in 1969. That section exempts charitable annuities from the unrelated business income tax rules when the value of the gift part of the annuity is more than 10 percent and some other tests are met. Had Congress intended that gift annuities be subject to section 501(m), enacted last year, it would have repealed section 514(c)(5), but it did not.

Gift annuities could be taxed twice if both Sections 514 and 501(m) are applicable, a result that we believe Congress could not have intended.

The fact that Congress did not even mention, let alone repeal, section 514(c)(5) means, in our view, that section 501(m) does not apply to charitable gift annuities.

And to conclude, we ask for the simple clarifying, technical amendment that states that gift annuities meeting the tests of section 514(c)(5) are not subject to section 501(m). That amendment would allow charities to continue to obtain an important source of support from lower and middle class individuals, and that support benefits our country.

Senator BAUCUS. Thank you very much, Mr. Teitell. Our next witness is Dr. Michael Malone. And let me say for those of you who don't know him, Michael Malone is from Boseman, Montana, Montana State University, and we probably should have had him up on a prior panel because he has written several books. One of them which I commend to everyone is "The Battle For Butte." It is a terrific book about Butte, Montana, and it is great history, it is great lore, and we are very honored to have you here, Mr. Malone.

[The prepared written statement of Mr. Teitell follows:]

The Committee on Gift Annuities.

Mr. Chairman and Members of the Committee:

I am Conrad Teitell, a member of the White Plains, New York law firm of Prerau & Teitell, and appear on behalf of:

The Committee on Gift Annuities, a coalition of over 1,100 religious, educational and social welfare institutions and other institutions exempt under Section 501(c)(3) of the Code; and

The National Association for Hospital Development, a coalition of over 1,200 hospitals and health care institutions exempt under Section 501(c)(3).

The Council for the Advancement and Support of Education, a coalition of over 2,800 colleges, universities and other educational institutions exempt under Section 501(c)(3), joins in this testimony.

I. Technical Clarification Requested.

We believe Congress did not intend that charitable gift annuities be subject to Section 501(m) of the Code. The Technical Corrections Act should clarify that charitable gift annuities meeting the tests of Section 514(c)(5) are not "commercial-type insurance" within the meaning of Section 501(m).

Specifically, we ask that Section 501(m) be amended by deleting "and" appearing at the end of subparagraph (C), changing the period following subparagraph (D) to a comma and adding the word "and" following the comma, and adding a new subparagraph (E) thereto, to read as follows:

"(E) providing charitable gift annuities that meet the tests described in Section 514(c)(5)."

Background. The Tax Reform Act of 1986 added new Section 501(m) to the Internal Revenue Code of 1986 to restrict nonprofit organizations from unfairly competing with for-profit insurance companies in the sale of commercial insurance. Under Section 501(m), charitable and social welfare organizations that engage in providing "commercial-type insurance" will either lose their tax exemption or bear the burden of ordinary income tax on income earned through providing that insurance. The issuance of annuity contracts is included in the statute's definition of "insurance."

Traditional charitable gift annuities issued by charitable organizations are not, however, "commercial-type insurance." The Internal Revenue Service has recognized for more than 25 years that a charitable gift annuity is different from a commercial annuity. *See* Rev. Rul. 62-137, 1962-2 C.B. 28. The Internal Revenue Service also recognizes that the excess of the fair market value of gift property over the value of the annuity received from a charity constitutes a charitable contribution. Rev. Rul. 70-15, 1970-1 C.B. 20.

We are concerned that a misinterpretation of the term "commercial-type insurance" would subject gift annuities to new Section 501(m). This potential problem for charities (and the general public that benefits from their activities) should be clarified by the technical amendment suggested above.

II. What is a charitable gift annuity? A donor irrevocably transfers money or property to a charitable organization that promises to make fixed payments to the donor and/or another individual (e.g., the donor's spouse) for life. The donor makes a sizable charitable contribution because the payments are far smaller than the payments the donor could receive from a commercial annuity.

Gift annuities are not commercial in nature. The donor who receives payments under a gift annuity is not motivated to maximize his or her return, but rather to make a charitable gift. Indeed, under the Code, a donor who itemizes is entitled to a charitable contribution deduction equal to the value of the property transferred in excess of the present value of the payments the donor will receive (computed using Treasury tables).

We emphasize, however, that even with the charitable tax deduction (and many individuals who make annuity gifts get no deduction because they are nonitemizers), the donor still receives considerably less overall monetary benefit than a commercial annuity would yield.

Charitable organizations that provide gift annuities do not compete with life insurance companies that sell commercial annuities. Indeed, the person who makes an annuity gift is not even in the market for a commercial annuity. Rather, the donor wants to make a charitable gift and has selected a gift annuity as the method. Had the individual not made an annuity gift to a charity, he or she would not have purchased an annuity from an insurance company.

III. Gift annuities have been used for over 100 years as an important way for charities to get modest gifts from individuals who otherwise could not afford to make charitable gifts until death.

Typically, a prospective donor wishes to benefit a favorite charity, but may not be able to afford to live without at least some of the income from the gift. Therefore, the donor gives cash or property to a charity in return for an annual income stream -- the annuity. The donor, typically a lower- or middle-income individual, is thus able to fulfill his or her charitable desires currently, but retains the right to a portion of the property's income for his or her support.

Without this long-established fund-raising method, many taxpayers would be unable to make modest gifts, and the nation's charities (and the individuals they serve) would suffer.

Wealthier individuals can accomplish exactly the same result by creating a more formal charitable remainder annuity trust. (It is clear that those trusts are not subject to Section 501(m)). Because of the administrative expenses involved in establishing and maintaining a charitable remainder annuity trust, the charitable gift must generally be in the $50,000 - $100,000 range. Thus, the smaller donor makes his or her gift using the charitable gift annuity arrangement. A gift annuity is sometimes referred to as a "poor man's charitable remainder annuity trust."

IV. Charitable gift annuities are not subject to Section 501(m) because they are not "commercial-type insurance."

Individuals who buy insurance from tax-exempt organizations such as Blue Cross/Blue Shield may do so because Blue Cross/Blue Shield's tax exemption enables it to provide health insurance at or below market cost. In contrast, donors who receive gift annuity payments could purchase the same income stream in the market place for a much smaller amount than they have transferred to a charity.

Donors who make annuity gifts do so because they want to make a charitable gift and choose the gift annuity method because it best suits their donative desires and income needs. A charity is not competing for the dollars of an individual who would otherwise be in the market for a commercial annuity.

V. Charitable gift annuities are already governed by Section 514(c)(5), enacted by Congress in 1969.

Background on Section 514(c)(5). Before enactment of the Tax Reform Act of 1969, a small number of tax exempt organizations had engaged in debt-financed acquisitions ("*Clay Brown* type" transactions) that benefited the seller and allowed the tax-exempt purchaser to acquire a business without any investment of its own funds, and thus to immunize itself from any risk of loss. The charity's tax-exempt status enabled it to pay a higher price for the business than other purchasers could afford, thus giving it an unfair competitive advantage over taxable purchasers.

The Treasury Department's study that preceded the Tax Reform Act of 1969 frequently referred to the problem of "unfair competition." The House Ways and Means Committee report on the 1969 Act referred to the need to tax charities "to the extent that they enter into commercial transactions of the market place in direct competition with taxpaying businesses." *See* Treasury Department Study at p. 318; House Committee Report at p. 40 (Statement of Hon. Edward S. Cohen).

In response, Congress added Code Section 514 to tax the unrelated business income produced by exempt organizations' debt-financed property. However, Congress expressly excepted gift annuities from this rule as long as the value of the annuity is less than 90 percent of the contributed property and other tests are met. *See* Code Section 514(c)(5).

If Congress had intended gift annuities to be subject to Section 501(m), it would have repealed Section 514(c)(5). But it did not. Indeed, gift annuities could be taxed twice if both Sections 514 and 501(m) were applicable, a result that Congress could not have intended. The fact that Congress did not even mention -- let alone repeal -- Section 514(c)(5), requires the conclusion that Section 501(m) is inapplicable to charitable gift annuities.

VI. Conclusion: Section 501(m) should be clarified to remove needless uncertainty and confusion regarding the tax status of charitable gift annuities.

A simple, clarifying technical amendment would allow charities to continue to obtain an important source of lower- and middle-class support for worthy causes that benefit our country.

STATEMENT OF DR. MICHAEL MALONE, DEAN OF GRADUATE STUDIES, MONTANA STATE UNIVERSITY, TESTIFYING ON BEHALF OF THE COUNCIL OF GRADUATE SCHOOLS IN THE UNITED STATES, BOZEMAN, MT, ACCOMPANIED BY JOHN F. JONAS OF PATTON, BOGGS & BLOW, WASHINGTON, DC

Dr. MALONE. Thank you, Senator Baucus. I appreciate those comments. And thank you for the opportunity to speak on behalf of graduate education in the United States.

My name is Michael Malone. I am the Dean of Graduate Studies at Montana State University in Bozeman, MT. And I am accompanied by counsel. I am speaking on behalf of several organizations that represent universities in the United States: the Council of Graduate Schools in the United States; the National Association of State Universities and Land Grant Colleges; the American Association of Universities; and the National Association of Independent Colleges and Universities.

I would like to speak to you if I may extemporaneously and avoid some of the technical language that is in the formal presentation that is in front of you.

The main concern that we have, especially at the Council Graduate Schools, is the considerable uncertainty in the 1986 Tax Code relating to the taxation of income of graduate students in American universities. In this case, especially graduate teaching assistants and graduate research assistants.

If I may use Montana State University as an example, the largest university in my State and Senator Baucus' State, we are completely typical at Montana State in that we reward graduate students and graduate assistants essentially in two ways. We pay them stipends, which essentially are salaries, and we grant them what we call in Montana fee waivers, and the language of the presentation of there is tuition remission scholarships. But a tuition remission and a fee waiver, of course, is the same thing. Let me explain that.

A graduate stipend on our campus—and we are a bit at the low end I think of State universities—runs about $6,000.00 per 10-month academic year. That stipend is essentially a remuneration for service performed, either university research or classroom teaching. It is meant both to assist the student in getting an education, but, of course, it is also a remuneration for services performed. And we accept the logic that those stipends are taxable income. The fee waivers or tuition remissions, however, we would argue are something entirely different. These are not remuneration for services rendered, but they are a literal waiver of fees due. The purpose is not compensation for service. The main purpose of the fee waiver is to assist students in getting an education. And I think its demonstration of that, the Legislature of Montana, like I think most States, groups the funding for waivers with scholarships, but the funding for stipends for graduate students are grouped with the salaries of other employees.

So what our request is, we believe that it is the traditional policy of the intent of Congress to exempt these fee waivers or scholarships from taxation, and we believe that is the intent of the 1986 Code.

The problem is that section 127 of the Code provides the exemption of these waivers, but section 117 of the Code still subjects them to taxation. So I would ask you on behalf of these organizations to please end this inconsistency and clarify that section 127 of the Code prevails over section 117 of the Code, demonstrating clearly that graduate tuition remissions or fee waivers are not subject to taxation.

This is a revenue neutral request. Believe me, the uncertainty that this is causing among graduate assistants, hundreds of thousands of them, in this country is causing some to consider not going on to graduate school, which I think is very much not in the national interest.

So I would ask you, Senators, to please consider clarifying that 127 prevails. Thank you for your attention. And it was a privilege speaking here.

Senator BAUCUS. Thank you, Dr. Malone.

Next is Mr. Blanchette.

[The prepared written statement of Dr. Malone follows:]

STATEMENT OF DR. MIKE MALONE

Mr. Chairman, I am Dr. Mike Malone, and am the Dean of Graduate Studies at Montana State University at Bozeman. I am appearing on behalf of the Council of Graduate Schools in the United States. I am here today in support of a proposed technical correction to section 127(c)(8) (copy attached). This correction assures that the intent of the conferees in extending section 127 is carried out; namely that graduate students engaged in teaching and research can continue to exclude from taxable income their tuition remissions grants. The correction serves to resolve any inconsistencies between section 117's provisions for qualified scholarship exemption and section 127(c)(8)'s exclusion for tuition remission grants.

The core problems are as follows: 1) although Section 117 generally exempts scholarships and fellowships up to a ceiling of tuition and fees from taxation, it subjects to taxation all payments that represent compensation for services, presumably to include tuition remissions for TAs and RAs (teaching and research assistants); 2) this treatment of TA and RA tuition remissions is now in conflict with 127(c)(8), which states that such support is tax-exempt; 3) Congress should resolve the conflict in favor of 127(c)(8) because that is the proper policy at the graduate level where teaching and research are a fundamental part of the educational process and because that implements Congressional intent as stated in the House Report. Congress should also correct the language in Section 117 to end the awkward cross-reference.

Early in the House consideration of the Tax Reform Act of 1986, it was decided to make the non-tuition portion of scholarships and fellowships subject to tax. We do not believe that there was any debate over the status of fellowships that contain teaching or research components. At a later date in the development of the 1986 Tax Bill, section 127 was extended to continue employer-provided tuition benefits. Section 127(c)(8) excludes tuition reduction grants from taxable income even where some teaching or research is required. The House Report (H. Report 436, 99th Congress, 1st Session 102, 7 Dec. 1985) makes note of this as follows:

> "In addition, section 1161 of the committee bill extends the availability of the tuition reduction exclusion for certain graduate students an additional two taxable years beyond its scheduled expiration for taxable years beginning after December 31, 1985, as part of the extension of section 127 under the bill."

No specific mention of these topics is made in the Conference Report on the Tax Reform Act except the general notation that the conferees adopted the House provisions.

Given the peculiar cross-reference between section 117 and section 127, it is understandable why confusion exists. However, what legislative history that does exist on this obscure provision (H. Report language) seems to strongly indicate that until section 127 expires at the end of 1987, graduate students could continue to exclude tuition remission scholarships.

Section 127 was added to the code to allow employers to provide non-discriminatory education benefits to their employees. Prior to its adoption great confusion existed as to what was excludable under section 162 as an ordinary and necessary business expense (retraining) and what was not excludable (new skills). A similar situation exists in this case as well. Trying to separate out in the case of a graduate research assistant in molecular biology what amounts of his/her tuition waiver constitutes compensation for some type of service and what constitutes an educational activity is almost impossible. The sounder tax policy is clearly to recognize that the primary purpose of tuition waivers is not compensation, but education. Most of the services provided have extremely limited, if any, commercial value. Where stipends are provided as payment for services a taxable event occurs. This is consistent with the 1986 revisions to Section 117. Section 127 rightly excludes tuition remission grants from taxation. In addition, such a result is completely consistent with the primary provision in tax reform which subjected room and board to taxation, but continued to provide tax-free tuition scholarships. A result contrary to the one we are seeking would produce the anomalous situation in which an individual could receive a tax-free scholarship to study geology, but an individual who receives a tuition scholarship to study biology which had a teching or research requirement would be subject to tax.

Thank you for this opportunity to testify. I hope that the Committee adopts our proposed clarification. I'd be pleased to answer questions about our policies at Montana State University or any other aspects of this issue.

PROPOSED CORRECTION

In order to clarify the scope of the cross-reference to Section 117(c) contained in Section 128(c)(8), the following technical amendment should be adopted:

Paragraph (8) of Section 128(c) is amended to read as follows:

> "COORDINATION WITH SECTION 117(d). -- In the case of an individual who is a graduate student at an educational organization described in Section 170(b)(1)(A)(ii) and who is engaged in teaching or research activities for such organization, Section 117(d)(2) shall be applied as if it did not contain the phrase "below the graduate level" <u>and without regard to the limitation contained in paragraph (c) of that Section [117]</u>."

STATEMENT OF HON. KEVIN BLANCHETTE, REPRESENTATIVE, STATE OF MASSACHUSETTS AND CHAIRMAN, NATIONAL CONFERENCE OF STATE LEGISLATURES PENSIONS SUBCOMMITTEE, TESTIFYING ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES, LAWRENCE, MA

Mr. BLANCHETTE. Thank you, Mr. Chairman and Senator Roth. My name is Kevin Blanchette. I am a member of the Massachusetts House of Representatives and chairman of the Joint Public Service Committee there. I also serve as the chairman of the National Conference of State Legislatures Pensions Subcommittee. On behalf of the National Conference of State Legislatures, I want to thank you for the opportunity to testify on pension issues for the Technical Corrections Act to the Tax Reform Act of 1986.

Mr. Chairman and Senator Roth, the most comprehensive tax overhaul in this country's history has left State government with the onerous task of analyzing tax reform's impact on State and local public pension systems and public employees.

The broad scope of tax reform produced unintended consequences for public employee retirement systems and public employees of State and local governments. Specifically, the National Conference of State Legislatures has identified three grave concerns: the mandate of distribution of pension benefits at age 70 and a half (Section 1122) which preempts State retirement policy and potentially jeopardizes the fiscal integrity of State retirement systems; second, the repeal of the 3-year recovery rule (Section 1121) which penalizes public employees who make after-tax contributions to retirement; and, third, the Treasury Department interpretation of the modifications to section 457—that is section 1107—which jeopardizes the deferred tax status of elective contributions to retirement by broadening the definition of an elective contribution to include factors outside of the employee's ability to control.

The National Conference urges Congres to exempt State and local governments from the Tax Reform Act mandatory distribution of pension benefits at age 70 and a half. With the passage of the Tax Reform Act as well as the Age Discrimination in Employment Act of 1986, which eliminated mandatory retirement at age 70, a situation was created where an employee could simultaneously receive full salary, draw retirement benefits and accur additional retirement credits. The conflict between the two laws preempted many State retirement policies which provide, by statute, that retirement is a prerequisite for commencement of pension benefits.

Because Americans are living longer, healthier lives, and many are working out of economic necessity, more employees are choosing to continue working long after normal retirement age. The Tax Reform Act's mandate will, therefore, significantly increase State pension funding requirements and the amount of time needed to finance pension benefits.

Retirement systems must immediately begin planning for the 70 and a half mandate of increased pension benefits for the 20 to 40 year olds currently in our work force. The 20 to 40 year olds, or the baby boomers, constitute a third of the nation's population. In 20 years, all retirement systems will feel the burden of an estimated 10 million baby boomers reaching retirement age. By the year

2030, it is estimated that all of the baby boomers will have reached retirement age.

The 70 and a half mandate will put a financial burden on State and local public retirement systems at a time when many systems will be unable to shoulder this unwarranted additional fiscal responsibility.

To date, 24 States have reported budget reductions and at least 11 States have enacted tax increases in order to meet constitutional mandates of a balanced budget.

The Tax Reform mandate will, for example, add an $87.4 million pension liability to the budget of the State of Texas. This liability would be imposed at a time when Texas is trying to balance its budget while providing essential services with dwindling revenues.

Although my State of Massachusetts is one of the few States still enjoying a modest revenue surplus, we are beset by an unfunded pension liability totaling over $11 billion, a debt that will only worsen with this new Federal requirement.

Because most States base retirement benefits on years of service and final salary computations, distribution of pension benefits at age 70 and a half will increase the complexity of record keeping and computation requirements of employee benefits for State systems by requiring continual adjustment of pension benefits and accruals with any fluctuation in salaries.

If the 70 and a half mandate is not met, public employees will be put in a precarious position of potentially losing half of their monthly retirement check. This would be, in effect, a 50 percent federal excise tax. This excise tax poses a substantial reduction for public employees who are dependent upon their retirement income to make ends meet.

The rule of mandatory distribution at age 70 was enacted in order to preclude highly paid private sector individuals from using retirement savings plans as vehicles to shelter income in estate planning. Few public employees are highly compensated. In Massachusetts, a State employees earns on average, a modest yearly income of $25,000. Because most State employees are dependent upon their pensions to provide income during retirement, they usually do not have the luxury of delaying the start of their pensions. Moreover, the tax sheltering mechanism used by highly compensated private sector employees is simply unavailable to most public workers. The National Conference believes that the financial security of State employees and retirement systems should not be jeopardized by Tax Reform scatter-gun approach to a private sector problem.

We also urge the Congress to mitigate the negative effects of the repeal of the 3-year recovery rule on employees and retirement systems of State and local governments. Because most State pension plans require after-tax contributions of their employees, the repeal of the 3-year recovery rule has had a substantial impact on the public sector.

Unlike other retirement plans, employees participating in these State and local pension plans are unable to defer or to deduct their contributions to retirement savings from federal income tax. Instead, their contributions must be made on an after-tax basis. To reconcile this disparity in tax treatment, the Federal Government had permitted public employees to accelerate the recovery of their previously taxed contributions in the first three years of receipt of pension benefits.

With the enactment of the Tax Reform, the 3-year recovery rule was retroactively repealed for all employees retiring after July 1, 1986. The new basis recovery rule, which requires public employees after-tax contributions to be proportionately recovered over the life of the annuity, does not recognize the disparity between tax treatment of public employee pension contributions and that of other retirement savings contributions.

Senator BAUCUS. Could you quickly wrap up, please, Mr. Blanchette?

Mr. BLANCHETTE. All right. I am sorry, Mr. Chairman.

The retroactive nature of the repeal is unfair, and we ask that this be addressed and that the Congress mitigate some of the negative impact.

We also call upon the Congress to clarify the law regarding the 457 change and the Treasury Department's interpretation to expand and to broaden the definition of elective deferral.

In summary then, Mr. Chairman, I thank you for the opportunity to address this committee regarding the Technical Corrections. The Nation's 50 State legislatures are struggling to address the problems. And we ask that you, as our national Legislature, recognize the distinct character of State and local government employment and permit State and local governments the flexibility to effectively manage their work force by correcting the problems caused by the Tax Reform Act. Thank you.

Senator BAUCUS. Thank you very much. We appreciate it. Mr. Kies.

[The prepared written statement of Mr. Blanchette follows:]

NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. Chairman, my name is Kevin Blanchette. I am a member of the Massachusetts House of Representatives and Chairman of the Joint Public Service Committee. I also serve as the Chair of the NCSL Pensions Subcommittee. On behalf of the National Conference of State Legislatures, thank you for this opportunity to testify before you on pension issues for the Technical Corrections Act of 1987 (H.R.2636 and S.1350) to the Tax Reform Act of 1986 (TRA), P.L.99-514.

The most comprehensive tax overhaul in this country's history has left state government with the onerous task of analyzing tax reform's impact on state and local public pension systems and employees.

The broad scope of tax reform produced unintended consequences for public employee retirement systems and employees of state and local governments. Specifically, the National Conference of State Legislatures (NCSL) has identified as grave concerns:

- the mandate of distribution of pension benefits at age 70 and a half (Section 1122) which preempts state retirement policy and potentially jeopardizes the fiscal integrity of state retirement systems;

- the repeal of the three year recovery rule (Section 1121) which penalizes public employees who make after-tax contributions to retirement; and

- the U.S. Department of Treasury interpretation of the modifications to Section 457 (Section 1107) which jeopardizes the deferred tax status of elective contributions to retirement by broadening the definition of an elective contribution to include factors outside of the employee's ability to control.

Exempt State and Local Governments From Mandatory Distribution of Pension Benefits At Age 70 and a Half:

NCSL urges Congress to exempt state and local governments from TRA's mandatory distribution of pension benefits at age 70 and a half. With the passage of TRA and the Age Discrimination in Employment Act of 1986, which eliminated forced retirement at age 70, a situation was created where an employee could simultaneously receive full salary, draw retirement benefits and accrue additional retirement credits. The conflict between the two laws preempted many state retirement policies which provide, by statute, that retirement is a prerequisite for commencement of pension benefits.

Because Americans are living longer, healthier lives and many are working out of economic necessity, more employees are choosing to continue working long after "normal" retirement age. TRA's mandate will, therefore, significantly increase state pension funding requirements and the amount of time needed to finance pension benefits.

Retirement systems must immediately begin planning for the 70 and a half mandate of increased pension benefits for the 20 to 40 year olds currently in our work force. The 20 to 40 year olds, or the baby boomers, constitute a third of the nation's population. In 20 years, all retirement systems will feel the burden of an estimated 10 million baby boomers reaching retirement age. By the year 2030, it is estimated all of the baby boomers will have reached retirement age.

The 70 and a half mandate will put a financial burden on state and local public retirement systems at a time when many systems will be unable to shoulder this unwarranted additional fiscal responsibility. To date, twenty-four states have reported budget reductions and at least 11 states have enacted tax increases in order to meet constitutional mandates of a balanced budget.

TRA's mandate will, for example, add an $87.4 million pension liability to the budget of the State of Texas.[1] This liability would be imposed at a time when Texas is trying to balance its budget while providing essential services with dwindling revenues.

Although my state of Massachusetts is one of the few states still enjoying a modest revenue surplus, we are beset by an unfunded pension liability totaling over $11 billion, a debt that will only worsen with this new federal requirement.

Because most states base retirement benefits on years of service and final salary computations, distribution of pension benefits at age 70 and a half will increase the complexity of record keeping and computation requirements of employee benefits for state systems by requiring continual adjustment of pension benefits and accruals with any fluctuation in salaries.

[1]Clayton T. Garrison, Executive Director of Texas Public Employees' Retirement System, to Robert J. Leonard, Washington, D.C., 6 July 1987.

If the 70 and a half mandate is not met, public employees will be put in the precarious position of potentially losing half of their monthly retirement check. This would be, in effect, a 50 percent federal excise tax. This excise tax poses a substantial reduction for public employees who are dependent upon their retirement income to make ends meet.

The rule of mandatory distribution at age 70 was enacted in order to preclude highly paid private sector individuals from using retirement savings plans as vehicles to shelter income in estate planning. Few public employees are highly compensated. In Massachusetts, a state employee earns on average, a moderate yearly income of $25,200. Because most state employees are dependent upon their pensions to provide income during retirement, they usually do not have the luxury of delaying the start of their pensions. Moreover, the tax sheltering mechanism used by highly compensated private sector employees is simply unavailable to most public workers. NCSL believes that the financial security of state employees and retirement systems should not be jeopardized by TRA's scatter-gun approach to a private sector problem.

Mitigate Negative Effects of Repeal of the Three Year Recovery Rule on State and Local Employees:

We urge Congress to mitigate the negative effects of the repeal of the three year recovery rule on the employees and retirement systems of state and local governments. Because most state pension plans require after-tax contributions of their employees, the repeal of the three year recovery rule has had a substantial impact on the public sector.

Unlike other retirement plans, employees participating in these state and local pension plans are unable to defer or deduct their contributions to retirement savings from federal income tax. Instead, their contributions must be made on an after-tax basis. To reconcile this disparity in tax treatment, the federal government had permitted public employees to accelerate the recovery of their previously taxed contributions in the first three years of receipt of pension benefits.

With the enactment of TRA, the three year recovery rule was retroactively repealed for all employees retiring after July 1, 1986. The new basis recovery rule, which requires public employee after-tax contributions to be proportionately recovered over the life of the annuity, does not recognize the disparity between tax treatment of public employee pension contributions and that of other retirement savings contributions.

The retroactive nature of the repeal is grossly unfair to state and local employees who retired after July 1, 1986, but before January 1, 1988. In essence, those individuals suffer a double penalty of the loss of the three year recovery rule under the new tax law and taxation at the higher, pre-TRA tax rates.

Secondly, the unexpected repeal of the three year recovery rule did not allow public employees adequate time to plan for the change in the tax treatment of their pension benefits. Because of the suddenness of the repeal, the financial security of many retiring state and local employees was impaired.

The new basis recovery rule and U.S. Department of Treasury regulations are inflexible and do not adequately address the variety of benefit options and types of benefits that determine the amount of an employee's pension benefits. For Massachusetts' state retirement system and the 101 local pension systems, Treasury's regulations do not consider the complicated nature

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and combination of types of benefits and various benefit options that state or local systems may offer.

We urge you to mitigate the negative effects of the repeal of the three year recovery rule and the onerous administrative requirements of the new basis recovery rule on state and local employees and retirement systems.

Ensure that Deferrals to State and Local 457 Plans Are Non-Elective:

NCSL calls upon Congress to clarify the law to ensure that employee contributions to non-elective, unfunded deferred compensation plans of state and local governments and tax-exempt organizations under Section 457 are not subject to taxation until the benefit is actually distributed to the employee.

The U.S. Department of Treasury announced its intent to broaden the definition of an elective deferral to include deferrals based on factors outside of the employees' control in Internal Revenue Bulletin No. 1987-4. With this broader interpretation, the Department of Treasury has clearly violated the legislative history and intent of Congress. By definition, a non-elective deferral is one over which the employee has no control, such as one set by an employer based on such factors as salary or years of service.

For state and local employees, this means vacation leave, sick leave, survivor benefits, and even severance pay could now be considered in the $7,500 yearly limit on contributions to 457 retirement plans. These non-elective benefits would inflate and accelerate an employee's contribution to retirement and potentially cause an employee to violate the yearly $7,500 limit on retirement contributions. Any contributions over the $7,500 limit would be penalized with a 10 percent excise tax.

In addition, Treasury's proposed retroactive treatment of what it considers to be deferred contributions could potentially result in the retroactive taxation of an employee's contributions to retirement and in the taxation of other employee benefits which the employee may never have the benefit of actually receiving.

Conclusion

In 1986, the Congress rewrote the nation's tax laws to provide a more equitable and simple form of taxation. However, for the employees and retirement systems of state and local governments, tax simplification was not simple.

In many cases, the consequences of tax reform pose serious threats to the fiscal integrity of state pension systems and the retirement plans of millions of state and local workers. The nation's 50 state legislatures are struggling to address these problems. We ask that you recognize the distinct character of state and local governmental employment and permit state and local governments the flexibility to effectively manage their work force by correcting the problems caused by the Tax Reform Act.

STATEMENT OF KENNETH J. KIES, BAKER & HOSTETLER, TESTIFYING ON BEHALF OF THE SECTION 457 TASK FORCE, WASHINGTON, DC

Mr. KIES. Thank you, Mr. Chairman, Senator Roth.

My name is Ken Kies. I am a partner with the law firm of Baker & Hostetler. I appear here in my capacity as the designated representative of the 457 Task Force. Following up on the last witness' comments, the purpose of the task force, which is a broad-based coalition of both State and local government employers and tax-exempt employers who are listed in my attached statement, is to urge the Congress to reverse an interpretation of a provision of the Tax Reform Act of 1986, which the IRS released in January of this year. That interpretation would require employers of both tax-exempt entities and State and local government entities to include in income of employees non-elective deferred compensation which those employees have not yet received, never had the right to elect to receive currently, and may never receive in the future if they either die or their employer becomes insolvent prior to the time payment is scheduled to occur. Taxation would occur at a time when those individuals do not have the income to pay such tax.

Section 457's origin goes back to the 1978 Act, at which time the Congress, in response to proposed regulations which the Internal Revenue Service had issued, dealing only with elective deferred compensation, in effect, reversed the regulations and provided that State and local government employees could defer on an elective basis that would not create current taxation up to $7,500 per year. Those regulations which section 457 reversed only dealt with elective deferred compensation.

In the President's tax reform proposal, the President proposed extending section 457 to the tax exempt community. In the description of the President's proposal, he indicated that he was extending the application to elective deferrals, never mentioning any application of this provision to non-elective deferrals. In fact, if you go back to the committee report from the 1978 legislation, which is quoted in my testimony, you will find that the Congress indicated that the provision which they were enacting at that time extended only to plans which provide an option to defer compensation and it is inapplicable to a State's regular retirement system, which does not provide an option to defer.

In the 1986 bill, the Congress extended 457 to tax-exempt entities. In January of 1987, for the first time the IRS took the position that section 457 applied to non-elective deferred compensation, a position that they had never taken publicly in the past.

The consequence, if that interpretation is not reversed, is that literally thousands of employees will have to be taxed on income currently they have not yet received and have never had a right to receive on a current basis. We believe that a reading of the legislative history, both of the 1978 Act and of the change that the Congress made in 1986, clearly indicates that the Congress did not intend to apply section 457 to non-elective types of compensation, which includes vacation pay plans, severance pay plans, supplemental retirement plans, sick pay plans, all types of plans that many State and local government employers provide to their employees and types of plans which private tax exempt employers provide to their employees.

In conclusion, Mr. Chairman, we would urge the Congress as part of The Technical Corrections process to clarify that neither the 1986 Act provision nor the original 1978 Act provision was intended to apply to non-elective deferred compensation.

Thank you, Mr. Chairman.

[The prepared written statement of Mr. Kies follows:]

STATEMENT OF THE SECTION 457 TASK FORCE
BEFORE THE SUBCOMMITTEE OF TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEEE
S. 1350, THE TECHNICAL CORRECTIONS ACT OF 1987

Mr. Chairman, my name is Ken Kies. I am a partner with the law firm of Baker & Hostetler. I appear in my capacity as the designated representative of The Section 457 Task Force, a coalition of state and local government employers and private tax-exempt employers. This coalition believes that the IRS has incorrectly interpreted a provision of the Tax Reform Act of 1986 as it applies to employees of state and local government and private tax-exempt employers. The coalition urges the Congress to reverse this erroneous interpretation through the techncial correction process.

I. Background.

Section 1107 of the Tax Reform Act of 1986 (the "1986 Act") broadens the coverage of section 457 of the Internal Revenue Code (the "Code"). As a result, certain deferred compensation plans of tax-exempt organizations (other than state and local governments which were subject to section 457 before the 1986 Act) are subject to new rules. Generally, amended section 457 applies to tax-exempt organizations for taxable years beginning after December 31, 1986, although many existing plans are grandfathered under some circumstances for existing employees.

Tax-exempt organizations have expressed concern regarding the treatment of nonelective, nonqualified retirement plans (and other nonelective, employer-provided deferred benefits) under section 457. Likewise, state and local government employers have expressed similar concerns over the public position only recently taken by the Internal Revenue Service ("IRS") in Notice 87-13 regarding the scope of section 457 as originally enacted in 1978. The IRS position overstates the intended scope of section 457. This overstatement, in many cases, would require employees to pay tax on deferred benefits which such employees have no right to receive currently (and may never receive). In the case of affected state and local government employers, the IRS interpretation, if correct, probably requires an amendment to W-2 forms for affected employees and a concurrent amendment of such employees tax returns for all open tax years.

To allay the foregoing concerns and to reverse the erroneous IRS position, it is necessary to clarify the intended scope of section 457 in the Technical Corrections Act of 1987 (H.R. 2636). The balance of this memorandum discusses Code section 457 in the context of its legislative history, and explains why the general scope of section 457 which was not changed by the 1986 Act, should remain limited to non-qualified, elective deferred benefit arrangements. Nonqualified, nonelective retirement pay plans (as well as other nonelective deferred benefit plans) of both tax-exempt and state and local government employers should remain unaffected by section 457 in accordance with clear Congresssional intent.

II. Inapplicability of Section 457 to Nonelective, Non-Qualified Deferred Benefit Plans.

A. Deferred Compensation Rules Before 1978; Constructive Receipt Rule.

Prior to 1978, nonqualified deferred compensation arrangements were subject to broad statutory guidelines and regulations. A cash-basis employee included deferred amounts in income when those amounts were "actually or constructively received." Treas. Reg. 1.446-1(c)(1)(i); See also I.R.C. 451; Treas. Reg. 1.451-2 (constructive receipt of income). IRS administrative rulings further defined the income recognition rules for various nonqualified deferred compensation arrangements. See, e.g., Rev. Rul. 60-31, 1960-1 C.B. 174 (guidelines for applying rule of constructive receipt to deferred compensation arrangements), modified, Rev. Rul.

70-435, 1970-2 C.B. 100 (replacing one factual example). Under traditional constructive receipt principles, deferred amounts are not taxed currently unless they are "made available" to the taxpayer so that the taxpayer can elect to receive such amounts currently. See, e.g., Metcalfe v. Commissioner, 43 T.C.M. (CCH) 1393, 1396 (1982).

B. Proposed Regulation Section 1.61-16.

In 1978, the IRS published Proposed Regulation section 1.61-16 (the "Proposed Regulation"), which would have eliminated the ability of employees to defer compensation at their individual option. See 43 Fed. Reg. 4638 (Feb. 3, 1978). Specifically, the Proposed Regulation would have required all cash-basis taxpayers covered by elective, nonqualified deferred compensation arrangements to recognize deferred amounts as income in the taxable year such amounts otherwise would have been payable, rather than in the later taxable year when the deferred amounts actually were paid.

By its terms, however, the Proposed Regulation only affected those amounts deferred "at the taxpayer's individual option." Id. Thus, nonelective, nonqualified retirement plans that basically consisted of deferred commitments to pay benefits pursuant to a formula or schedule were not the target of the Proposed Regulation. Since the benefits under such plans were not attributable to amounts deferred "at the taxpayer's individual option," they would not have been covered by the Proposed Regulation. Thus, under established income recognition rules, employees would not be taxed on nonelective unfunded retirement benefits until payments actually were made.

The Proposed Regulation was designed primarily to eliminate elective deferral arrangements for state and local government employees (although, by its terms, it applied to elective deferral arrangements of all taxpayers). See, e.g., Fischer, Deferred Compensation: Born Again -- for Now, 37 N.Y.U. Inst. on Fed. Tax'n 28-1, 28-9 to 12 (1979) (discusses history of Prop. Reg. 1.61-16).

C. Congressional Response to the Proposed Regulation.

Congressional response was swift. Sections 131 and 132 of the Revenue Act of 1978 (the "1978 Act") specifically addressed most elective deferred compensation arrangements jeopardized by the Proposed Regulation. See Public Law 95-600, 92 Stat. 2779-83 (Nov. 6, 1978), reprinted in 1978-3 C.B. 13-17; see also H.R. Rep. No. 1445, 95th Cong., 2d Sess. 52-53, reprinted in 1978-3 C.B. 226-27 (reasons for change); S. Rep. No. 1263, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 363 (reasons for change); H.R. Rep. No. 1800, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 538 (reasons for change).

Section 131 of the 1978 Act created Code section 457, which applied to State and local government deferred compensation plans. Section 132 of the 1978 Act rejected application of the Proposed Regulation to deferred compensation plans of private, taxable employers. In section 132(a) of the Act, Congress pronounced that the legal principles governing private deferred compensation plans would be those in effect on February 1, 1978 (two days before publication of the Proposed Regulation). Id. at 92 Stat. 2782-83, reprinted in 1978-3 C.B. 16-17.

D. Statutory Language and 1978 Legislative History Behind Section 457.

Section 457, by its terms, contemplates elective deferrals. See I.R.C. 457(b)(4) (agreement or arrangement providing for deferral); Treas. Reg. 1.457-2(b), 2(g) (same). Within the context of section 457, the very concept of "deferred compensation" presupposes a right or option to receive economic benefits currently, which benefits are deferred by agreement.

The legislative history confirms without ambiguity that the limitations on "deferred compensation plans" of state and local governments were never intended to apply to nonqualified retirement pay plans which were unfunded and nonelective (i.e., employer-provided retirement plans with no elective or salary-reduction features):

> The treatment provided by [section 457] for an ineligible State deferred compensation plan extends only to plans which provide an option to defer compensation and is inapplicable to a State's regular retirement system (whether or not such plan is a tax-qualified plan) which does not provide such an option.
>
> [H.R. Rep. No. 1445, 95th Cong. 2d Sess. 57, reprinted in 1978-3 C.B. 231 (emphasis added).]
>
> The tax treatment of participants in an ineligible State deferred compensation plan does not extend to participants in the State's regular retirement plan (whether or not qualified under 401(a)).
>
> [S. Rep. No. 1263, 95th Cong., 2d Sess. 70, reprinted in 1978-3 C.B. 368 (emphasis added).]

When discussing the effect of section 457 on tax revenues, both the House and Senate Reports affirmed that section 457 continued "the existing tax treatment" of deferred compensation plans "within certain limitations." See H.R. Rep. No. 1445 at 58, reprinted in 1978-3 C.B. 232; S. Rep. No. 1263 at 71, reprinted in 1978-3 C.B. 369.

Section 457 was a response to the Proposed Regulation which addressed only elective deferral arrangements which were the subject of that Regulation. Both the House and Senate Reports regarding section 457 consistently referred to elective or contractual deferral arrangements. Further, there is no discussion in the legislative history to indicate that unfunded welfare benefit plans (e.g., sick pay or vacation pay plans, survivor benefit plans or severance pay arrangements) were ever intended to be subject to the "deferred compensation" rules of section 457.

In effect, sections 131 and 132 of the 1978 Act were designed to permit elective deferrals by State and local government employees within specified limitations and unlimited elective deferrals by other employees. The Congress thereby retreated from the position taken in the Proposed Regulation, which would have required current income recognition of all elective deferrals. No change had ever been suggested, either in the Proposed Regulation or in section 457, regarding the tax treatment of unfunded, nonelective deferred benefits (e.g., regular retirement plans, welfare benefit plans or survivor benefit plans). Thus, section 457 was clearly intended to be a relief provision.

Two other provisions of the 1978 Act also dealt with employee elections and their effect on current taxable compensation. 1978 Act Sections 134 and 135 created Code sections 125 (cafeteria plans) and 401(k) (cash or deferred arrangements), respectively. See Public Law 95-600, 92 Stat 2783-87 (Nov. 6, 1978), reprinted in 1978-3 C.B. 17-21. Neither Code section 125 nor Code section 401(k) refers to section 457, but all three of those sections impose limitations on an employee's ability, by agreement or election, to avoid or defer taxation on certain forms of employee benefits. In fact, Code section 125 was coordinated indirectly with section 457, since "deferred compensation plans" were excluded from the general cafeteria plan provisions. See id. at 92 Stat. 2784 (Code section 125(d)(2)), reprinted in 1978-3 C.B. 18.

It has been suggested that the absence in section 457 of words like "elect" or "choose" (which are used in sections 125 and 401(k)) manifests that Congress did not intend to limit section 457 to elective deferred benefits. But section 457 consistently refers to "agreements" or "arrangements" by employees to defer compensation. A reference in section 457 to "elective" deferred compensation would have been redundant. Therefore, especially when read in light of its legislative history, it seems clear that section 457 should apply only to elective unfunded deferrals.

E. Confusion Regarding the Scope of Section 457.

Despite clear indications that section 457 applied only to elective deferrals (e.g., salary reduction arrangements), the elective/nonelective distinction was either ignored or forgotten in some instances.

One of the first sources of confusion is the Joint Committee's General Explanation of the Revenue Act of 1978 (the "1978 Blue Book"). The 1978 Blue Book accurately summarizes the history behind section 457 and the reasons Congress chose to limit deferred compensation arrangements for State and local government employees, citing the concern over "plans involving an individual election to defer compensation." See id. at 68. But the 1978 Blue Book's "Explanation of Provision" contains the following statement about section 457:

> The rules prescribed by the Act apply whether or not exployees [sic] and independent contractors are provided with an individual option to defer. [Id.]

While it is not clear with respect to what the above-quoted language has reference, it cannot be interpreted to mean that nonelective deferred benefits are subject to section 457 without being in direct conflict with the legislative history of the 1978 Act with respect to section 457.

A few years later, apparently due to some uncertainty as to the IRS's position regarding the application of section 457 to unfunded retirement plans, a provision which explicitly exempted certain nonelective judicial retirement plans from the section 457 rules was incorporated into the Tax Equity and Fiscal Responsibility

Act of 1982 ("TEFRA"). See TEFRA section 252, retroactively amending section 131(c) of the 1978 Act (enabling provisions of Code section 457). Although such nonelective plans should not have been affected by section 457 in any event, the Texas state judges sought to secure an ironclad statutory exemption and succeeded.

The "Reasons for Change" in the Senate Report confirmed that the contribution limits and rules of Code section 457 should not be applied to State judges' unfunded "defined benefit" retirement plans which had no elective features:

> Because the participant's benefit under such a [retirement] plan generally does not depend upon the participant's account balance, the committee believes it is inappropriate to apply contribution limits or other rules designed for defined contribution plans.
>
> [S. Rep. No. 494, 97th Cong., 2d Sess. 328 (1982).]

Unfortunately, the Senate Report suggested a defined-contribution/defined-benefit distinction as the line of demarcation for "appropriate" application of section 457. The elective/nonelective distinction was temporarily submerged.

Shortly after TEFRA was enacted, the Department of Treasury ("Treasury") issued final Regulations for Code section 457. While the Regulations themselves did not explicitly address the elective/nonelective issue, the preamble to those Regulations contained the following statement:

> [I]n the absence of statutory authority to provide for the exclusion of [unfunded regular retirement] plans from section 457(e)(1) and without clearer legislative guidance as to what form this exclusion should take, it has been decided that it is inappropriate to provide for this exclusion through regulations. Consequently, deferrals under an unfunded regular retirement plan of a State will be considered to be made under an ineligible plan, and not excludible from income under section 457(a).
>
> [47 Fed. Reg. 42336 (Sept. 27, 1982).]

Ignoring the ample legislative history indicating that nonelective, unfunded retirement plans are outside the ambit of section 457, Treasury suggested that all unfunded deferred benefit plans (except those specifically enumerated in section 457(e)(1)) had been swept away under the guise of section 457. Apparently, Treasury was unwilling to make an elective/nonelective distinction notwithstanding the presence of legislative history which indicated that section 457 was intended to apply only to elective deferral arrangements. No attempt was made to incorporate this provision into the regulations, evidencing apparent uncertainty on the part of the Treasury with respect to its own position.

F. The 1986 Act.

The 1986 Act originated from The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985)("President's Proposal"). The President's Proposals included the proposed extension of section 457 to all tax-exempt employers. As described in the President's Proposals, the change in section 457 would affect elective deferrals by employees:

> The rules permitting the elective deferral of compensation by employees of States on a nonqualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code. Thus, an employee of a tax-exempt employer would be permitted to defer, on an elective basis and subject to the same limitations currently applicable to State employees a portion of his or her current compensation under a nonqualified and unfunded arrangement maintained by the employer (an **"eligible deferred compensation plan"**). Compensation deferred by an employee of a State or tax-exempt employer under an ineligible deferred compensation plan would be includible in the employee's gross income when there is no longer a substantial risk of forfeiture.
>
> [President's Proposal, Chapter 14.10 at 381 (emphasis added).]

There is no indication that Code section 457, as then in effect, was understood to apply to anything but elective deferral arrangements. In fact, the tenor of Treasury's description of the changes suggests that the employees of the tax-exempt community would be receiving a benefit from the extension of section 457, a suggestion clearly inconsistent with an extension of section 457 to nonelective deferred compensation.

Generally adopting the President's Proposals, the 1986 Act extended section 457 rules to tax-exempt employers. 1986 Act section 1107, H.R. Rep. No. 841, 99th Cong., 2d Sess. at I-361 to 366. The operative language of section 457 remained substantially the same, except for the deferral coordination rules of section 457(c) and the new distribution rules of section 457(d).

The Conference Report accompanying the 1986 Act gives no indication of any Congressional intent to expand the scope or nature of plans encompassed by section 457. See id. at II-397 to 400. And the Joint Committee's General Explanation of the Tax Reform Act of 1986 (the "1986 Blue Book"; published May 4, 1987) confirms that section 457 "continues to apply to the same types of deferred compensation to which it applied under prior-law." Id. at 654. Thus, although the 1986 Act expanded the group of employers affected by section 457, it did not change the type or nature of deferred compensation plans subject to the section 457 rules.

The same types of nonelective, unfunded retirement plans maintained by state or local governments which always were beyond the intended scope of section 457 similarly should remain beyond the scope of amended section 457 as it applies to such plans maintained by tax-exempt organizations. For example, nonqualified, nonelective retirement pay plans with no salary reduction features should remain unaffected by section 457, whether they are maintained by governmental entities or tax-exempt organizations.

III. Notice 87-13 and Examples of Plans to which Section 457 Should Not Apply.

On January 5, 1987, the IRS released Notice 87-13 (published January 26, 1987 in Internal Revenue Bulletin No. 1987-4), which contained the preliminary IRS views regarding the scope and application of Code section 457. At Q&A-26, the IRS adopted the following position:

> Section 457 applies to amounts deferred under a deferred compensation plan regardless of whether the plan is in the nature of an individual account or defined contribution plan or a defined benefit plan, including a deferred compensation plan that provides benefits in excess of the benefits provided under a qualified plan under section 401(a), a deferred compensation plan that provides benefits in excess of the benefits permitted to be provided under a qualified plan on account of section 415, and a deferred compensation plan that provides benefits only to a select a group of executives or other highly compensated employees (e.g., a "top hat" plan). Also, section 457 applies to amounts deferred even though deferred amounts are determined by reference to factors other than the annual compensation of the individual (e.g., years of service, final average salary), uncertain in aggregate amount, and are payable over an indeterminable period (e.g., over the life of the individual).
>
> Section 457 applies to amounts deferred under a deferred compensation plan, whether or not such deferral is pursuant to the election of the individual taxpayer. Thus, section 457 applies to both elective and nonelective deferred compensation amounts.
> [1987-4 I.R.B. at 26.]

The extreme position adopted by the IRS disregards the historical distinction between the tax treatment of employee elective deferrals and employer-provided, nonelective deferred benefits.

The IRS position threatens many unfunded retirement programs and other benefit programs (e.g., vacation pay and sick pay plans) maintained by tax-exempt organizations and State and local governments. It is understood that some State and local government employees participate in both (i) an "eligible deferred compensation plan" under section 457 (which generally permits elective deferrals up to $7,500 per year), and (ii) a nonelective unfunded retirement plan which provides an annuity form of retirement benefit based upon years of service and final average compensation. The IRS apparently intends to treat such retirement plans as "ineligible" plans subject to section 457. Such an interpretation could result in the retroactive taxation of benefits "accrued" under such retirement plans since as far back as 1978.

Section 457 contemplates agreements by employees with employers whereby limited elective deferrals may be made with favored tax treatment. Thus, section 457 should properly be interpreted to affect only unfunded salary reduction agreements whereby an employee elects to forego current compensation in exchange for unfunded future payments.

IV. Revenue Impact and Administrative Concerns

State and local governments have administered elective deferred benefit plans under section 457 since 1978. Under the 1986 Act, the same rules limiting elective deferrals will apply to tax-exempt employers. The suggested legislative clarification would explicitly exclude nonelective deferral arrangements from the section 457 rules. Since such nonelective arrangements never were intended to provide revenue under section 457, their continued exclusion should have no adverse impact on projected tax revenues.

On the other hand, the unwarranted interpretation of section 457 adopted by the IRS would result in current taxation of nonelective deferred benefits. Employees of both tax-exempt organizations and state and local governments would have to recognize as current income the "present value" of hypothetical deferred benefit "accruals." The accurate valuation of these accruals would be virtually impossible in many cases. If the employee did forfeit benefits or if the employer became insolvent before the nonelective deferred benefits were paid, such employees would have paid tax on income never received and with respect to "benefits" over which they had no control or right to demand current payment. Such treatment would be totally at odds with the entire history of the Federal individual income tax system under which individual taxpayers are taxed on the cash basis method of accounting.

Affected employers would confront administrative nightmares coordinating elective and nonelective deferred benefit plans if both involuntary "accruals" and elective employee deferrals were subject to section 457 limits. Further, employees would perceive the current taxation of deferred income over which they have no control as grossly unfair.

V. Conclusion.

In light of the IRS pronouncement in Notice 87-13, the Congress should now take the opportunity to clearly state that section 457 does not apply to nonelective deferred compensation. As a part of that process, the distinction between elective and nonelective deferrals also could be clarified, most easily through illustrations and examples made part of the legislative history. The Section 457 Task Force is prepared to work with the Ways and Means Committee to assist in any way with this effort.

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July 14, 1987

Mr. Kenneth J. Kies
Baker & Hostetler
Washington Square, Suite 1100
1050 Connecticut Avenue, N.W.
Washington, D.C. 20036

Re: Section 457 Task Force - Technical Corrections Act of 1987

Dear Mr. Kies:

Representatives of the Church Alliance have reviewed the materials that you will be forwarding to the Ways & Means Committee on behalf of the Section 457 Task Force, and we are in hearty agreement with the relief that you are requesting therein. The Church Alliance has submitted its own comments on the section 457 issue, and the Church Alliance also submits that section 457 has never covered, and should not cover, nonelective deferred compensation arrangements.

We in the Church Alliance look forward to working closely with you and the other members of the Section 457 Task Force to make sure that nonelective deferred compensation arrangements are preserved for the 28 mainline denominations represented through the Church Alliance.

Sincerely yours,

Gary S. Nash

Gary S. Nash,
Church Alliance Secretary

Senator BAUCUS. Thank you, Mr. Kies.

Each of you has very forcefully advocated the changes you think we should make and I want to thank each of you. I have no further questions. Senator Roth, do you have any questions?

Senator ROTH. Yes.

As I understand it, the current situation is that a wealthier person can set up a trust to achieve the benefits of making a gift to an institution that is not available to the lower or medium income individual because of the cost of setting up a trust. Is that correct?

Mr. TEITELL. Senator Roth, you are quite correct. This gift that we are talking about is really the poor person's way of making a charitable gift. Wealthier taxpayers make gifts, and those are very, very important gifts and charities benefit. So I think that we would want to encourage their gifts also. But these larger gifts are not subject to section 501(m). We don't believe charitable gift annuities are subject to that section either. And we ask that Congress clarify that they are not.

Senator ROTH. In other words, the technical correction that you are proposing would encourage the individual with small or medium income to make charitable gifts?

Mr. TEITELL. Yes, sir, that is correct. There is a section of the Code that already deals with charitable gift annuities enacted back in 1969. And if Congress had intended 501(m) to apply to charitable gift annuities, we believe it would have had to repeal that other section, because otherwise charities can be taxed if they do not meet the test twice on one transaction. I don't think Congress intended that.

Senator ROTH. Let me ask you a second question. Isn't it also true that the smaller gifts are particularly important in many cases to your smaller——

Mr. TEITELL. They are very, very important too.

Senator ROTH [continuing]. Schools?

Mr. TEITELL. The Salvation Army.

Senator ROTH. The Salvation Army.

Mr. TEITELL. The Cancer Society, the Red Cross. Many of the people who make these gifts are non-itemizers and they don't even get a charitable deduction for their gift.

Senator ROTH. So this is their one means of really making a significant contribution?

Mr. TEITELL. Yes, Senator Roth, that is correct.

Senator ROTH. Thank you, Mr. Chairman.

Senator BAUCUS. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

We have had a good deal of correspondence on the problems raised by Mr. Teitell, and Dr. Malone and Mr. Blanchette, and I want to say that I am sympathetic to those problems you have described.

Now, Mr. Simons, I was not aware of the problems that you raised, but looking over your statement, I think they deserve attention too.

Mr. SIMONS. Thank you.

Senator CHAFEE. Let's tackle those.

I want to thank each of the witnesses. Is it Kies or Keys?

Mr. KIES. Kies, Senator Chafee.

Senator CHAFEE. Kies. Again, that is one I am not so familiar with. I want to go into that one too. So thank you all very much.

Senator BAUCUS. We all thank you very much.

Senator ROTH. Mr. Chairman, if I might just say, as I listen to these gentlemen and their concerns, which I agree with Senator Chafee, they make very valid points, I have to admit I am very pleased that I voted against the Tax Reform Act. [Laughter.]

Senator BAUCUS. Thank you all. Thank you very much. We appreciate your testimony.

Our final panel will include Mr. John Kent, Director of the Federal and International Taxes, GTE Service Corp.; Mr. Richard Merski, director of Government Affairs for the American International Group; Mr. Robert V. Van Fossan, chairman of the board, Mutual Benefit Life; and Mr. Jack Park, vice president of Government Relations for the Coalition of Maritime Companies and Associations. Mr. Kent, you are on top of the list. Why don't you begin.

STATEMENT OF JOHN KENT, DIRECTOR, FEDERAL AND INTERNATIONAL TAXES, GTE SERVICE CORP., STANFORD, CT

Mr. KENT. Thank you, Mr. Chairman, Senators Roth and Senator Chafee. I am John Kent, Director of Federal and International Taxes for GET Service Corp. I appreciate the opportunity to appear before the distinguished subcommittee to discuss the need for technical corrections to correct an unintentional potential inequity in the rules enacted in the 1986 Tax Reform Act affecting investment tax credit carryovers from 1986 forward.

Investment tax credit, as you well know, is one of the principal items funding the 1986 Tax Reform legislation through its repeal, and it was one of the few items which was affected by the legislation on a retroactive basis, all the way back to the beginning of 1986.

To make matters worse for those taxpayers generating investment tax credits, a number of other provisions were put in the legislation to reduce the value of the investment tax credit and the availability for its use where it was useable.

For example, binding contract rules were given a retroactive date; the limitation on the investment tax credit that could be used to offset tax liability was decreased from 85 percent to 75 percent; the credit itself was reduced from 10 percent to 8.5 percent, and then 6.5 percent to reflect the effect of the tax rate reduction that was occurring. A full ITC basis adjustment was imposed versus the one-half percent investment tax credit basis adjustment of existing law.

When the legislative language in the Conference Committee Report were released, it became evident that a technical problem could exist for a taxpayer generating an investment tax credit in 1986 that could not be claimed on a tax return until a later year. Such a taxpayer is obviously someone who could least afford to pay additional taxes. A very inequitable, illogical situation could develop for such taxpayer.

A full investment tax credit basis adjustment would be made to the asset placed in service in 1986 of 10 percent so that only 90 percent of the asset could be depreciated for tax purposes. Then an investment tax credit of 8.25 percent, or 6.5 percent, would be claimed on a tax return in a later year, leaving a portion of the asset not eligible for depreciation or investment tax credit.

I have attached to my testimony a very simple example, a 1-page example, showing the impact of what could happen to various taxpayers in like circumstance getting different results.

A Further compounding of this inequity could occur if the taxpayer disposed of the asset and caused an investment tax credit recapture. Basis would be restored, looking to the investment tax credit claimed, not the actual original basis adjustment. Tax could be owed on gain that did not in fact exist.

The clear inequity of this situation is borne out by the fact that a taxpayer placing an asset eligible for investment tax credit in service in 1987 makes an 8.25 investment tax credit basis adjustment, and claims the exact same amount on investment tax credit on its tax return. It is not difficult to imagine how these technical problems could creep into such an enormously complicated piece of legislation.

General tax policy considerations, the need for a level playing field, and, most importantly, fairness dictate that this situation be clarified by allowing a revision to Section 49 of the Internal Revenue Code to provide for an upward basis adjustment on the basis of divestible property for any reduction in allowable investment tax credit that could occur in a carryover situation.

Thank you.

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

Mr. Merski, please proceed.

[The prepared written statement of Mr. Kent follows:]

STATEMENT
ON
H. R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987
BY
JOHN P. Z. KENT, DIRECTOR - FEDERAL/INTERNATIONAL TAXES
GTE SERVICE CORPORATION
SUBMITTED TO THE
TAXATIONS AND DEBT MANAGEMENT SUBCOMMITTEE
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 22, 1987

The Tax Reform Act of 1986, H. R. 3838, repealed the investment tax credit ("ITC") on a retroactive basis, effective January 1. 1986, and placed new limitations on the taxpayer's ability to use it to offset U. S. income tax liability, where ITC was still available due to a carryover situation or transitional relief. The tax reform legislation also reduced the value of ITCs from 10% in 1986 to 8.25% in 1987 and to 6.5% in 1988 and succeeding years for calendar year taxpayers in order to reflect the fact that the corporate tax rate is being reduced from 46% to 39.95% in 1987 and 34% in 1988. At the same time, the Tax Reform Act of 1986 reduced the value of ITC for "transition property" (basically, property placed in service after 1985 not eligible for or subject to the new modified depreciation system) by requiring a full ITC basis adjustment, as opposed to the one-half ITC basis adjustment of existing law. This full ITC basis adjustment means that the depreciable basis of property qualifying for transition relief is reduced by 10% in 1986, 8.25% in 1987 and 6.5% in 1988, consistent with the amount of ITC earned in those years.

Congressional intent, as enunciated in the Conference Committee Report, is certainly clear that the basis of property to be depreciated should be reduced by the amount of ITC being used to offset U. S. income taxes. The tax statute itself, however, is not clear that in the case of an ITC carryover from 1986 to 1987 or from 1987 to 1988 that the basis of property is reduced by the same amount as the ITC being actually used by the taxpayer on a tax return. In those two instances it is possible that the depreciable basis of property may be reduced by more than the amount of ITC utilized (for example, the basis could be reduced by 10% and the taxpayer only use an 8.25% ITC due to a carryover from 1986 to 1987). Clearly, this would be an inequitable result which is not consistent with the treatment of other ITCs being generated in the same year that the carryover ITC is being uitilzed and the intent of Congress in enacting this legislation. I have attached, as Exhibit A, a simple example which illustrates the possible "mismatching" that could occur between the depreciable basis of a capital asset investment and the related ITC utilized if this situation is not clarified and placed in its proper order by the Technical Corrections Act of 1987. Further inequity could also occur in a disposition of such asset in an ITC recapture situation where the proper amount is not restored to basis.

The most appropriate way to correct any possible misunderstanding with regard to this matter would be to revise Section 49 of the Internal Revenue Code of 1986 to allow for an "upward adjustment" in the basis of depreciable property for any reduction of allowable ITC that occurs in a carryover situation through The Technical Corrections Act of 1987. This type of treatment is consistent with legislative history in similar situations and achieves fairness in the treatment of similarly situated taxpayers that is one of the principal objectives of the Tax Reform Act of 1986. The technical correction could be accomplished in any number of ways and if the Subcommittee deems it appropriate, I stand ready to submit suggested statutory language.

I deeply appreciate the attention of this distinguished Subcommittee to this technical correction of the tax statute and respectfully submit that such correction is logical, fair and consistent with past and present legislative treatment and intent relating to ITC legislation.

Exhibit A

POTENTIAL EFFECT OF TAX REFORM ON INVESTMENT TAX CREDIT (ITC) CARRYFORWARDS

IF YOU INVEST $100 IN A CAPITAL ASSET IN 1986 AND CLAIMED ITC IN 1986.

DEPRECIATION BASIS ADJUSTMENT		ITC	
$100.00	BASIS	$100.00	BASIS
($ 10.00)	BASIS ADJUSTMENT	10%	ITC
$ 90.00	ADJUSTED BASIS	$ 10.00	ITC

IF YOU MADE THE SAME INVESTMENT IN TRANSITION PROPERTY IN 1987 OR 1988.

CREDIT TAKEN	DEPRECIATION BASIS ADJUSTMENT		ITC	
1987	$100.00	BASIS	$100.00	BASIS
	($ 8.25)	BASIS ADJUSTMENT	8.25%	ITC
	$ 91.75	ADJUSTED BASIS	$ 8.25	ITC
1988	$100.00	BASIS	$100.00	BASIS
	($ 6.50)	BASIS ADJUSTMENT	6.50%	ITC
	$ 93.50	ADJUSTED BASIS	$ 6.50	ITC

IF YOU HAVE AN ITC CARRYFORWARD FROM 1986 AND CLAIM IT IN 1987 OR 1988.

CREDIT TAKEN	DEPRECIATION BASIS ADJUSTMENT		ITC	
1987	$100.00	BASIS	$100.00	BASIS
	($ 10.00)	BASIS ADJUSTMENT	8.25%	ITC
	$ 90.00	ADJUSTED BASIS	$ 8.25	ITC
	$1.75 NON DEPRECIABLE BASIS			
1988	$100.00	BASIS	$100.00	BASIS
	($ 10.00)	BASIS ADJUSTMENT	6.50%	ITC
	$ 90.00	ADJUSTED BASIS	$ 6.50	ITC
	$3.50 NON DEPRECIABLE BASIS			

STATEMENT OF RICHARD P. MERSKI, DIRECTOR, GOVERNMENT AFFAIRS, AMERICAN INTERNATIONAL GROUP, WASHINGTON, DC

Mr. MERSKI. Thank you, Mr. Chairman, members of the committee.

My name is Richard Merski. I am director of Government Affairs for American International Group, a worldwide insurance operation.

AIG appreciates the opportunity to present its views on proposed corrections to The Technical Corrections Act of 1987. In particular, I wish to focus my remarks on a matter which, although technical in nature, is of great importance to AIG, the treatment of investment income attributable to insurance of risk within the same country of incorporation of a controlled Foreign Corporation.

Under last year's Tax Reform Act, Section 953 of the Code for the first time taxes the insurance income earned by a U.S. controlled foreign corporation if the income is derived from the foreign risk situated outside of the country of the company's incorporation.

For example, if a U.S. owned Hong Kong incorporated company writes risks situated in Singapore through its Hong Kong office, insurance income from the Singapore risk is taxed, but if the risks are situated in Hong Kong, there is no U.S. tax until dividends are paid to the U.S. owner.

Traditionally, insurance income includes both underwriting and investment income. However, when eliminating deferral for U.S.-owned foreign banks, Congress struck from the Code Section 954(c)(2) which had the effect of inadvertently overriding the retention of deferral for the same country risk on insurance income as provided by current Code Section 953.

Effectively overriding the retention of deferral for the same country risk puts U.S.-owned international insurers at a significant competitive disadvantage in all foreign jurisdictions having effective foreign tax rates below 34 percent since the U.S.-owned insurers would be paying a higher of the U.S. or local tax rate.

Our foreign competition then would only be paying the local rate of taxation.

Your support is requested to clarify in technical corrections the retention of deferral for investment income from risk insured in the same country as the insurer is incorporated. To accomplish this, section 954(c) of the Code would be amended to exclude from the definition of foreign personal holding company income in the Code, certain investment income, which I have outlined further in detail in my prepared remarks, that is derived from the insurance or reinsurance of risks derived in the country in which the insurer or reinsurer is organized.

And for purposes of this amendment, a branch of a foreign corporation licensed and predominantly engaged in the insurance business in a foreign country should be treated as a separate foreign corporation.

Accepting these amendments will allow application of the same tax policy theory under subpart F of the Code for U.S.-controlled foreign insurance companies as is applied to all other U.S.-owned foreign incorporated industries, other than banks and shipping for which deferral was eliminated entirely.

In closing, I should note that there is no possibility of abusing the suggested insurance rule by manipulating or transferring income from high tax to low tax jurisdictions since the source, location and amount deferred is fixed by statutory language.

Thank you.

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

Our next witness will be Mr. Robert Van Fossan.

[The prepared written statement of Mr. Merski follows:]

STATEMENT OF RICHARD MERSKI
AMERICAN INTERNATIONAL GROUP, INC.
on
S.1350, the Technical Corrections Act of 1987
before
The Senate Finance Committee
Subcommittee on Taxation and Debt Management
July 22, 1987

Mr. Chairman and members of the Committee, my name is Richard Merski. I am the Director of Government Affairs of the Washington office of American International Group, Inc. ("AIG"), which through its subsidiaries is primarily engaged in a broad range of insurance and insurance-related activities in the United States and abroad. AIG appreciates the opportunity to present its views on proposed corrections to the Tax Reform Act of 1986 (the "Reform Act") being made by S.1350, the Technical Corrections Act of 1987. In particular, I wish to focus on a matter which, though technical in nature, is of great importance to AIG -- the treatment of investment income attributable to insurance of risks within the same country of incorporation of a controlled foreign corporation ("CFC").

Current Law

The Reform Act expanded the definition of Subpart F income by defining "insurance income" under Section 953(a) to include any income derived from the insurance or reinsurance of risks in connection with property located in, liability arising out of activity in, or in connection with the lives or health of residents of a country other than the country in which the CFC is incorporated. The Reform Act was intended to apply to insurance income earned on CFC insurance risks outside the country in which the corporation is organized. AIG does not believe it was Congress' intent to apply to underwriting and investment income attributable to insurance of risks within the same country in which the corporation is incorporated or where it is conducting an active business in such fashion so that the income cannot be manipulated from a high tax jurisdiction to a low tax jurisdiction. This interpretation is consistent with the statement in the House report that investment income taken into account under Section 953 of the Code is not treated as foreign personal holding company income under Section 954 of the Code:

> "Second, income of any kind received by an offshore insurance company, including income derived from its investments of funds, will generally be subject to taxation under Section 953, as described below. Regulations under present law specify that taxation of an insurance company's income under Section 953 takes precedence over its treatment as foreign personal holding company income. Thus, dividends, interest, and gains derived by a controlled foreign insurance company will not generally be treated as foreign personal holding company income in any event, if they are instead taken into account under Section 953." H.R. Rep. No. 99-426, 99th Cong. 1st Sess. at p. 399 (December 7, 1985).

Issues

The removal of the exclusion previously contained in Section 954(c)(2) of the pre-Reform Act Code to Subpart F for investment income derived from the necessary reserves of an insurance company or its necessary surplus is inconsistent with the retention of the same country exception for insurance income as provided in Section 953 and inconsistent with the long established concept in the Code that investment income generated on insurance reserves, unearned premiums, and necessary surplus should be considered insurance income. For example, investment income attributable to insurance of related party risks is subject to the new Subpart F provisions relating to captive insurance companies. Deductions for reserves allowed under Subchapter L are also adjusted under the Reform Act to reflect in part the time value of money and tax exempt interest on investments of reserves. The Tax Reform Act of 1984 also required that the source of insurance income (underwriting and investment income) derived by a CFC from insurance of U.S. risks be determined by reference to the risks insured.

The absence of an explicit exclusion for investment income attributable to insurance of risks within the country of incorporation is also inconsistent with the general treatment of non-financial companies. The whole concept of Subpart F income and the term "foreign base company" reflects the concept that United States shareholders should be taxed only on income which is passive in nature or income diverted from a related person in one jurisdiction to a CFC organized in a different foreign country. This is clearly reflected in the definitions of the various items which constitute foreign base company income and the specific exclusions for income from the same country of incorporation. Congress has never consciously extended the scope of Subpart F to include income derived from the active conduct of a trade or business in the same country in which the CFC which earns it is organized, in part because extension of that principle would force U.S. controlled business to bear higher rates of tax than foreign competitors.

In the absence of a technical amendment to the Reform Act a CFC which is an insurance company will be subject to significant overtaxation on its true taxable income because its taxable foreign personal holding company income will not take account of the deductions which would otherwise be allowed against underwriting and investment income if it were a domestic corporation. This can best be understood in the case of a controlled foreign life insurance company, where practically all of such a company's "taxable income" under Subpart F is attributable to the investment income which will be returned to policyholders. A domestic life insurance company is allowed a current deduction against all of its gross income under Section 805(a) of the Code for the net increase in its reserves, policyholder dividends, and other specified amounts, but no such deduction would reduce foreign personal holding company income under Subpart F. Under Section 954(b)(5) of the Code, foreign personal holding company income and other foreign base company income are reduced, under regulations, by deductions properly allocable to such income. Under current Treasury regulations, however, deductions allowed to a controlled foreign life insurance company reduce "gain from operations", i.e., underwriting income taken into account under Section 953, and not foreign personal holding company income. Treas. Reg. § 1.954-1(c), § 1.952-2(b)(2) and § 1.953-4.

Recommendation

The Technical Corrections Act should amend Section 954(c) of the Code to exclude from the definition of a foreign personal holding income, income derived by an insurance company from the investment of:

(i) unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business,

(ii) an amount of its assets equal to one-third of its premiums earned on insurance contracts (other than life insurance and annuity contracts), and

(iii) in the case of a life insurance company, an allocable portion of surplus determined under principles analogous to those under Section 813 of the Code, in each case attributable to the insurance (or reinsurance) of risks arising in the country in which the insurer (or reinsurer) is organized.

For purposes of (i), (ii), (iii), and Section 953(a), a branch of a foreign corporation licensed and predominantly engaged in the insurance business in a foreign country shall be treated as a separate foreign corporation created under the laws of the country in which the branch is licensed.

Explanation

The exclusion allowed by the proposed amendment would be available only to an "insurance company", *i.e.*, a corporation which would be taxable under Subchapter L if it were a domestic corporation. This will require that the corporation's primary and predominant business activity during the taxable year be the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Treas. Reg. § 1.801-3. Amounts not excluded would be subject to tax under Section 953 or other provisions of Section 954.

The amount of the exclusion under the proposed amendment can be objectively determined by a limiting mathematical calculation which is a function of the premiums produced and retained by the CFC if principles analogous to those in Treas. Reg. § 1.954-2(d)(3) are applied. Thus, unlike the situation of CFCs engaged in the conduct of the banking business which lost deferral on interest income in the Reform Act, there would be a strict and objective determination made.

Branches would also be treated as separate corporations under the proposed amendment for purposes of determining Subpart F insurance income consistent with Section 954(d)(3) of the Code, which now treats such a branch as a wholly owned subsidiary corporation for purposes of determining its foreign base company sales income. Such treatment is also consistent with the rules provided in Section 814 of the Code and its predecessors relating to U.S. life insurance companies operating in Canada or Mexico in branch form.*

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* For background information, see S.Rep. No. 94-938 (Part 1), 94th Cong. 2d Sess. at pp. 271-5 (1976), reproduced in 1976-3 C.B. (Vol. 3) at pp. 309-13.

STATEMENT OF ROBERT V. VAN FOSSAN, CHAIRMAN OF THE BOARD, MUTUAL BENEFIT LIFE, NEWARK, NJ

Mr. VAN FOSSAN. Thank you, Mr. Chairman, Senators Bradley, Chafee and Roth.

I am Robert Van Fossan, chairman and chief executive officer of Mutual Benefit Life Insurance Co. of Newark, NJ. I appreciate this opportunity to submit my comments regarding the increase in the capital gains tax rate on pre-1984 at market discount bonds proposal to increase that from 28 to 31.6 under the proposted Technical Corrections Act of 1987.

I recognize that this transition rule was not drafted by the Senate Finance Committee but rather initiated in the House. I felt it important, nonetheless, to bring to your attention our position on this matter which, throughout, has been for the adoption of a rule which treat all companies the same, a generic rule.

Mutual Benefit Life is a medium-sized mutual life insurance company which was a major participant in the issuance of guaranteed investment contracts in the early 1980's. These contractural commitments were made by my company to the holders of large contracts which support the nation's private pension system. These contracts were negotiated in an intensely competitive market resulting in very narrow profit margins. To support the long-term guarantees of the high interest rate then in effect—some 14, 15 or 16 percent—it was necessary to seek out investments which would not be redeemed as interest rates returned to more normal levels. Such redemptions would have created substantial losses to the company.

The best available investments with such safety were deep discount bonds. The company, in fact, passed on the capital gains differential to the pension plan buyers in the form of higher interest rate guarantees.

At the time of the enactment of the Deficit Reduction Act of 1984, these factors were seriously considered by the Senate and the House. A decision was reached in that Act to tax gain on bonds issued prior to July 19, 1984 at the traditional 28 percent rate. Mutual Benefit sought no more than that and has relied upon that law since.

The issue of a taxability of gain realized on these bonds was reconsidered in the 1986 Act. Ultimately, the House allocated $119 million to a transition rule to help solve that problem. Throughout these discussions, Mutual Benefit argued for a generic rule which would have treated all companies the same. However, at the time of enactment in those last frantic hours, available fragmentary data suggested that the 15 companies most concerned with that issue would use up the entire $119 million. Current, more accurate information, now shows that a generic rule would require $146 million to provide for the entire insurance industry at 28 percent.

If the Congress feels it should not allocate the additional money over the $119 million for a 28 percent rate, a 29.1 percent generic capital gains rate would accommodate the entire industry within the original $119 million guideline.

The Mutual Benefit is currently holding bonds purchased at market discount in reliance upon the provisions of the 1984 and

1986 tax Act. The differential between the corporate capital gains rate under the 15-company rule and the rate in The Technical Correction Amendment will cost us approximately $6 million in additional taxes. Such an increase in our taxes makes this provision more than a mere technical correction to us.

While an industry-wide generic rule was originally and still is most preferable, it is important that the rate originally applied to the 15-man companies not be raised substantially. The named insurance companies not only relied on the grandfather clause in the 1984 Act, but also relied on the transition rule as enacted. What is needed is a way to make the capital gains transition rule applicable to the entire industry while harming those of us in the industry without harming those of us who were granted relief.

I respectfully suggest and support your proposal to change the 15-company rule applicable to all insurance companies. But if, in your best judgment, the cost of generic treatment at 28 percent is still prohibitive, please redistribute to all insurance companies the $119 million of relief that was committed in the 1986 Act.

Thank you. And I would be happy to answer any questions.

Senator BAUCUS. Thank you very much, Mr. Van Fossan.

You are the final witness, Mr. Park.

[The prepared written statement of Mr. Van Fossan follows:]

REMARKS OF ROBERT V. VAN FOSSAN

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

OF THE MUTUAL BENEFIT LIFE INSURANCE COMPANY

Mr. Chairman: I am Robert V. Van Fossan, Chairman and Chief Executive Officer of The Mutual Benefit Life Insurance Company of Newark, New Jersey. I appreciate this opportunity to submit my comments regarding the increase in the capital gains tax rate on pre-1984 Act Market Discount Bonds from 28% to 31.6% under the proposed Technical Corrections Act of 1987. I recognize that this transition rule was not crafted by the Senate Finance Committee, but was initiated in the House. I felt it important, nonetheless, to bring to your attention our position on this matter which throughout has been for the adoption of a rule which treats all companies the same.

Mutual Benefit Life is a medium sized mutual life insurance company which was a major participant in the issuance of Guaranteed Interest Contracts in the early 1980's. These contractual commitments were made by Mutual Benefit to the holders of large contracts which support the country's private pension system. These contracts were negotiated in an intensely competitive marketplace resulting in narrow profit margins. To support the long term guarantees of the high interest rates then in effect (14% to 16%), it was necessary to seek out investments which would not be redeemed as interest rates returned to normal. Such redemptions would have created substantial losses to the Company. The best available investments with such safety were deep discount bonds. The Company, in fact, passed on the capital gains differential to the pension plan buyers in the form of higher interest rate guarantees.

At the time of the enactment of the Deficit Reduction Act of 1984, these factors were carefully considered. A decision was reached in that Act to tax gains on bonds issued prior to July 19, 1984 at 28%. Mutual Benefit sought no more than that, and has relied upon this law.

The issue of the taxability of gain realized on these bonds was reconsidered in the 1986 Act. Ultimately, the House allocated $119 million to a transition rule to solve the problem. Throughout these discussions, Mutual Benefit argued for a generic rule which would have treated all companies the same. However, at the time of enactment, available fragmentary data suggested that the 15 companies most concerned with this issue would use up the entire $119 million. Current, more accurate, information now shows that a generic rule would require $146 million to provide for the entire industry at 28%. If the Congress feels it should not allocate the additional money required for a 28% rate, a 29.1% generic capital gains rate would accommodate the entire life insurance industry within the original $119 million guideline.

The Mutual Benefit Life Insurance Company is currently holding bonds purchased at market discount in reliance upon the provisions of the 1984 and 1986 Tax Acts. The differential between the corporate capital gains rate under the 15 company transition rule and the rate in the Technical Corrections Act of 1987 will cost Mutual Benefit approximately $6 million in additional taxes. Such an increase in our taxes makes this

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provision more than a mere technical correction to us.

While an industry-wide generic rule was originally and still is most preferable, it is important that the rate that was originally applied to the 15 named life insurance companies not be raised substantially. The named insurance companies not only relied on the grandfather clause in the Deficit Reduction Act of 1984 when we made our initial investment, but also relied on the transition rule, as enacted, by not selling bonds in 1986 that we otherwise would have sold. What is needed is a way to make the capital gains transition rule applicable to the entire life insurance industry without harming those of us in the industry that previously were granted relief.

Mr. Chairman, I strongly urge you to change the 15 company rule to a rule applicable to all insurance companies. If in your best judgment the cost of generic treatment at 28% is still prohibitive, please redistribute to all insurance companies the $119 million of relief that was committed in the 1986 Act. A 29.1% rate will accomplish this.

STATEMENT OF JACK PARK, VICE PRESIDENT, GOVERNMENTAL RELATIONS, CROWLEY MARITIME CORP., TESTIFYING ON BEHALF OF THE COALITION OF MARITIME COMPANIES AND ASSOCIATIONS, WASHINGTON, DC

Mr. PARK. Thank you, Mr. Chairman, and Senators.

My name is Jack Park. I am vice president of Crowley Maritime Corp. I am representing today not only my own company but a large coalition of maritime companies and associations, a coalition encompassing the preponderence of the U.S. flag Merchant Marine and drilling rig owners. The names of these associations and companies are listed in my text.

We sincerely appreciate the opportunity to present our recommendations.

Although I and many of my colleagues spent a lot of time tracking the events that led to the passage of the Tax Reform Act, it came as a great surprise when we learned in March of this year that, though not specifically expressed in the bill, the cost of meals provided to crews on vessels and to personnel on drilling rigs was not fully deductible. Many of our companies' finance officers were incredulous.

Representatives from our coalition have spoken to staff members of the Ways and Means and Finance Committees, and though their reactions varied, one of the senior staff members was himself surprised. We sought to have a beneficial change incorporated in the Technical Corrections Act, as introduced, but no change was made. Such a correction should be made for several reasons.

First, it is a legal requirement to provide meals to merchant seamen. Such laws have applied since 1872. The latest revision to Title 46 of the U.S. Code made in 1983 requires that seamen be provided, and I quote, "Seamen shall be served at least three meals a day, to total at least 3,100 calories, including adequate water and adequate protein, vitamins and minerals in accordance with the United States recommended daily allowance.

"Second, as a practical necessity, meals must be provided by employers to crews on vessels and to personnel on drilling rigs."

They have nowhere else to go, no neighborhood cafe, no MacDonalds, no Popeyes.

"Third, meals provided to vessel crews and drilling rig personnel are as essential to doing business as other fully deductible costs." We could no more stop providing food, which fuels the body, than we could stop providing fuel for the vessels' engines.

"Fourth, 80 percent deductibility is directly contrary to the purposes of various statutes, making it a national policy to enhance the strength and competitiveness of our merchant marine."

In the House and Senate, committees are trying right now to find ways to save the merchant marine. The merchant marine has declined in number of companies, number of ships and personnel. While the right hand is trying to save the merchant marine, the left hand is applying punitive taxes.

Fifth, revenue to the Treasury from the 80 percent rule would be diminimus. We estimate $15 million a year. An amendment to the Technical Corrections Act of 1987 is described in the complete statements submitted by the Coalition which we urge be adopted.

Thank you very much for your time, and I will be pleased to answer questions.

[The prepared written statement of Mr. Park follows:]

Testimony of

Jack M. Park

Crowley Maritime Corporation

Good morning, Mr. Chairman and members of this Subcommittee on Taxation and Debt Management.

My name is Jack M. Park, Vice President, Governmental Relations, Crowley Maritime Corporation.

I am representing a large coalition of maritime companies and associations, a coalition encompassing the preponderance of the U.S.-flag merchant marine and drilling rig owners and related service industries. I am speaking today for:

AMERICAN COMMERCIAL BARGE LINE COMPANY (ACBL)
AMERICAN INSTITUTE OF MERCHANT SHIPPING (AIMS)
AMERICAN WATERWAYS OPERATORS, INC. (AWO)
COUNCIL OF AMERICAN FLAG-SHIP OPERATORS (CASO)
CROWLEY MARITIME CORPORATION
INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS (IADC)
INTERNATIONAL ASSOCIATION OF GEOPHYSICAL CONTRACTORS (IAGC)
MATSON NAVIGATION COMPANY
NATIONAL OCEAN INDUSTRIES ASSOCIATION (NOIA)
SEA-LAND CORPORATION
TOTEM OCEAN TRAILER EXPRESS (TOTE)
TRANSPORTATION INSTITUTE (TI)

The Tax Reform Act of 1986 reduces the deduction available to employers for the cost of meals provided to employees, as well as other meals considered ordinary and necessary business expenses, from 100% to 80%. Unfortunately, the IRS is applying this rule to meals being provided to crews of merchant vessels and offshore drilling rigs. Such a broad application of the 80% rule leads to the completely inequitable result that meals provided to such crews are treated just like other "business meals," including the infamous "three martini lunch," and "entertainment."

Meals provided to crews of vessels and drilling rigs are entirely different from other "business meals " They are not extravagant or lavish. They are the furthest thing from "entertainment" as defined in the Internal Revenue Code. And they are an absolutely essential aspect of operating vessels and drilling rigs.

The 100% deductibility of the cost of meals provided to crews of vessels and offshore drilling rigs should therefore be restored. In particular, such full deductibility should be restored because:

- <u>It is a legal requirement to provide meals to merchant seamen</u>. This federal law requirement dates back at least to 1872 and is backed by civil and criminal penalties. Owners and operators of drilling rigs are obligated by contracts to provide meals to crew members;
- <u>As a practical necessity, due to physical isolation, meals must be provided by employers to crews on vessels and drilling rigs</u>;
- <u>The penalty to vessel and drilling rig owners and operators is particularly unfair because meals provided to crews members must be provided at a high cost</u>;
- <u>Provision of meals to crew members of vessels and drilling rigs is just as essential an aspect of doing business as lifejackets for those same crew members which are fully deductible</u>;
- <u>80% deductibility is directly contrary to the purposes</u>

of various statutes making it a national policy to enhance the strength and competitiveness of our merchant marine;

- Meals provided to the crews of vessels and rigs are even more necessary and reasonable than meals exempted under the Tax Reform Act from the 80% deductibility requirement. For example, meals provided by restaurants and caterers to their employees are fully deductible; and,
- Revenue to the Treasury from the 80% rule would be de minimis. It is estimated that less than $15-million would be paid in additional taxes if the 80% rule is applied to meals provided to vessel crews and to personnel on drilling rigs.

The Provision of Meals to Merchant Seamen is a Legal Requirement

U.S. law requires vessel owners and operators to provide meals to their crews which alone makes these meals unique when considering that which the Tax Reform Act was intended to cover.

These statutory requirements that meals be provided to vessel crews are long-standing. At least as early as 1872 vessels with inadequate provisions were considered unseaworthy with serious legal ramifications. Act June 7, 1872, ch. 322, §36, 17 Stat. 269, *codified as* 46 U.S.C. §10902. As currently codified, the 1872 statute provides that "[a]ny 3 seamen of a vessel may complain that the provisions of food or water for the crew are, at any time, of bad quality, unfit for use, or deficient in quantity." 46 U.S.C. §10902(b)(1). If such complaint is found to have merit by the Coast Guard or local consul, the master of the vessel would be civilly liable. 46 U.S.C. §10902(b).

Later Congress went further and made it a criminal offense to withhold suitable food and nourishment from seamen. Act Dec. 21,1898, ch. 28, §22, 30 Stat. 761, codified as 18 U.S.C. §2191. Section 2191 of title 18 provides:

> Whoever, being the master or officer of a vessel of the United States, on the high seas, or on any other waters within the United States...withholds from the... [crew] suitable food and nourishment,... shall be fined not more than $1,000 or imprisoned not more than five years, or both.

Congress also provided for civil liability for the master or owner for the failure to provide "sufficient quantity of stores to last for a voyage of ordinary duration." Act Dec. 21, 1898, ch. 28, §12, 30 Stat. 758 (codified as 46 U.S C. §661 until 1983). And Congress mandated in detail what provisions had to be provided at a minimum. Act Dec. 21, 1898, ch. 28, §23, 30 Stat. 762 (codified as 46 U.S.C. §713 until 1983). For example, the following substitutes were some of the ones allowed:

> One pound of flour daily may be substituted for the daily ration of biscuit or fresh bread; two ounces of desiccated vegetables for one pound of potatoes or yams; six ounces of hominy, oatmeal, or cracked wheat, or two ounces of tapioca, for six ounces of rice.

As a result of the revision of Title 46 of the U.S. Code in 1983, Pub. L.No. 98-89, 97 Stat. 100, many of the anachronisms of the previous acts protecting seamen were eliminated, but the legislated mandate that seamen be provided meals remains. Seamen currently employed on vessels involved in foreign and intercoastal voyages "shall be served at least 3 meals a day that total at least 3,100 calories, including adequate water and adequate protein, vitamins, and minerals in accordance with the United States Recommended Daily Allowances." 46 U.S.C. §10303. The same requirement applies to vessels involved in coastwise voyages when a crew is engaged by a shipping commissioner. 46 U.S.C. §10507(b). Most importantly, regardless of the type of voyage, it remains a criminal offense punishable by fine and imprisonment to withhold suitable food and nourishment to seamen, 18 U.S.C. §2191; 46 U.S.C. §11507, and a vessel with insufficient provisions is still considered unseaworthy. 46 U.S.C. §10902. In this respect these meals are the same as providing lifejackets to the crew, also mandated by law but fully deductible.

Restoring 100% deductibility to meals provided to crews of vessels and drilling rigs is necessary to prevent an unwarranted hardship to two of America's most vital industries. The unique nature of the provision of meals to crew members by those industries should be recognized and distinguished in the Internal Revenue Code.

<u>Proposed Amendment</u>

It is recommended that the following proposed amendment to The Technical Corrections Act of 1987 be adopted:

Paragraph (2) of section 274(n) (relating to exceptions to the 80% limitation on deductibility of business meals) is amended by adding the following new subparagraph:

> "(E) such expense related to food and beverages provided to a qualified recipient."

Section 274(n) is further amended by adding new paragraph (4) to read as follows:

"(4) QUALIFIED RECIPIENT - For purposes of paragraph (2) (E), the term "qualified recipient" means any person who receives food and beverages while performing services for an employer either --

(A) aboard a commercial vessel as a crew member or officer;

(B) aboard an oil or gas drilling rig located offshore or in Alaska; or

(C) in a remote location where satisfactory meals are not available on the open market; but only if such food and beverages are furnished in a common area which is --

(i) located, as near as practicable, in the vicinity of the place at which such individual renders services, and

(ii) not available to the public and normally accommodates 10 or more employees."

Technical Explanation of Amendments to Section 274(n)

Section 274(n) provides that, as a general rule, only 80% of the cost of business meals are deductible. Paragraph (2) of section 274(n) contains certain exceptions to this general limitation on the deductibility of business meals. The proposed amendment adds an additional exception to the general rule for meals provided to crew members of commercial vessels, to employees working on certain drilling rigs, and to employees furnishing services at remote locations.

Under the proposed amendment, employers may deduct the full cost of meals provided to persons while they are performing services for an employer either (1) aboard a commercial vessel as a crew member, (2) aboard an oil or gas drilling rig located offshore or in Alaska, or (3) in a geographically remote location. To quality under the third prong of the proposed exception, limitations patterned after those set forth in section 119(c) must be satisfied. Thus, "remoteness" is tested under the amendment by reference to whether satisfactory meals are available on the open market. In addition, the place where the meals are provided must be located near the job site, not be available to the public, and must normally accommodate 10 or more employees.

Senator BAUCUS. Thank you all very much.

Mr. Kent, I think in all probability the interaction of the 100-percent basis reduction in the rule and the 35 percent ITC carry forward reduction was just not considered; that is, we didn't really think about the interaction of those two rules. And we are going to have to think about it now. But you make a good case. But I just wanted you to know I don't think this Congress paid any attention or not much attention to the interaction of those two rules.

Mr. KENT. That is our impression also.

Senator BAUCUS. Mr. Park, your proposal has some sympathetic feel, but how is IRS going to distinguish between those business meals that are really necessary meals and other business meals where the primary purpose is business but there is that personal element to it? And that is why we have this 80 percent rule. It is to try to make the best guess that the primary purpose is 80 percent. It is business, therefore, it is 80-percent deductible, maybe 20-percent not. But as an administrative matter, how would we distinguish between the two different kinds of business meals?

Mr. PARK. Mr. Chairman, I understand the question and the problem that you have expressed. We have attempted to provide three categories of groupings. One would be the people on vessels, which we think is clearly a situation in which the 100-percent deductibility should be applied. There is no alternative for them.

Second, we come up with a category—and these are listed in our proposed amendment—for offshore drilling rigs, which we think is similar to vessels, and to drilling rigs in remote areas, such as Alaska. Again, where there are no opportunities for alternative feeding systems.

The third category is a remote area, and probably that is the most difficult to define. But we have described it in ways which conform to previous identifications in the Tax Code on remote areas for other purposes. And so we feel that that is a good place to start to try to isolate those cases truly deserving of 100-percent deductibility.

Senator BAUCUS. It is not only drilling rigs and merchant marine. There are other meals that are in a captive like environment. One can think of all kinds of examples, to make it difficult again to administer. I appreciate what you are saying, but I am just trying to figure out the degree to which we could administer and separate to any kind of certainty those categories.

Mr. PARK. Well, first of all, I will have to admit that we did not try to develop the entire universe of people with legitimate claims to this same solution. And I would say that if they have legitimate reasons to be included, that they should be speaking up also. But I do think that the circumstances have been well enough defined in the Tax Code in the past in similar circumstances that it can be characterized adequately.

Senator BAUCUS. Thank you.

Senator Bradley?

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

Let me say that I think Mr. Van Fossan raises a unique situation. To my knowledge, in every other instance when there was a transition rule that was made generic, the full benefit of the original rule was preserved. That is my basic understanding. In other words, nobody lost anything from extending the transition rules to similar situated taxpayers. In this case, the group lost and I would say significantly. And I think it, frankly, deserves a sympathetic look from the committee. I think what would be helpful is, could you give us some sense, Mr. Van Fossan, of what the group actually has lost?

Mr. VAN FOSSAN. Well, it is relatively clear. The proposal that I raised would be to take it to a 29.1-percent rate which would utilize the $119 million in the original transition rule. That vis-a-vis the 28-percent rate. So as 1.1 percent on whatever the discount bond holdings the company had to back up those assets.

Senator BRADLEY. Uh huh.

But it does not raise the rate as high as it has been raised under the bill. In other words, your suggestion is to raise the rate to 29.1 down from 31 for all the beneficiaries of this——

Mr. VAN FOSSAN. For all the companies in the industry, Senator.

Senator BRADLEY. So that if you broadened the rule, made it generic so that not just the group but all share, then all ought to pay the higher rate.

Mr. VAN FOSSAN. That is right.

Senator BRADLEY. Is that not your argument?

Mr. VAN FOSSAN. That is right, sir.

Senator BRADLEY. As I said, Mr. Chairman, I think this is a unique situation and I thank you for your testimony.

Mr. VAN FOSSAN. Thank you so much, Senator.

Senator BAUCUS. Senator Roth.

Senator ROTH. Mr. Merski, as I understand your proposed amendment, it would be to treat non-financial institutions the same as, for example, manufacturing institutions are treated. Is that correct?

Mr. MERSKI. That is correct, Senator. Yes. The intent is to remove the disparity in the treatment. If I may, I could use an example of a manufacturing company. If a manufacturing company produced widgets in a foreign country through a foreign subsidiary of its own, then the income from the sale of those widgets in that country would not be taxed under subpart F even if sold to a related person in the same country. We would like to provide that treatment under our amendment for insurance companies. And the amendment would do so.

And I should add, or should emphasize that we are only talking about insurance on risks from unrelated parties, which is a narrower exclusion than the manufacturers have. So you are correct.

Senator ROTH. What kind of impact does the present situation have on your competitiveness in trying to enter a foreign market?

Mr. MERSKI. As I noted briefly in my remarks in my statement, it does put us at a significant competitive disadvantage vis-a-vis our foreign competitors, who have lower effective tax rates when comparing our Tax Code to theirs. So all operations, either through branches or outright controlled foreign corporations, put us at a substantial disadvantage.

Senator ROTH. Finally, does the suggested amendment avoid the opportunity to manipulate income from high tax to low tax jurisdictions or erode the United States revenue base?

Mr. MERSKI. The way the amendment is drafted it does not permit any tax base erosion or manipulation of income from high tax to low tax jurisdiction. There is a specific mathematical cap that limits the amount of income that can be excluded under the amendment from subpart F. So under our amendment, it does not provide for any manipulation of income to avoid tax.

Senator ROTH. Thank you, Mr. Chairman.

Mr. MERSKI. Thank you, Senator.

Senator BAUCUS. Thank you, Senator Roth. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Van Fossan, I am familiar with this problem you have got and I am sympathetic to it, because you made these contractural obligations based upon the situation as it then existed and with your deep discount bonds. Let me ask you this. If you had sold the bonds in 1986, I suspect that you would also have had an additional problem because you would have lost the protection of the 1984 grandfather clause. Is that correct?

Mr. VAN FOSSAN. That is right, Senator.

Senator CHAFEE. And that was not really a way out either for you. You were stopped there. Because I suppose, under the 1984 grandfather, you had to hold them to maturity.

Mr. VAN FOSSAN. Yes. But you had the additional fact that, true, the interest rates had dropped significantly, so the value of the bond was significantly less in 1986 than it would be obviously at maturity. So that is the other mitigating factor that was in the circumstances once you made that decision.

Senator CHAFEE. And I can think of a point here, that originally this started out getting the treatment at the 28 percent and then going, the compromise, if you would, is to go to the 29.1 percent, which, percentage-wise, is a pretty good increase. And absent that, what would be the percentage, 31.6?

Mr. VAN FOSSAN. 31.6 is the proposal in the technical correction bill, Senator.

Senator CHAFEE. Yes.

So I hope we could straighten this out in this Technical Corrections Act and to try to do so.

Mr. VAN FOSSAN. We thank you for your consideration, sir.

Senator CHAFEE. And as for the meals situation, Mr. Park, I must say, I was reading over your statement and it is pretty clear that the master goes to jail if he does not provide the proper meals for the crew.

Mr. PARK. That is true. However, I don't know of any circumstance recently where that has happened, I mean, where he has failed to provide the meals. But it illustrates the point.

Senator CHAFEE. But I mean that indicates pretty clearly that they are meant to provide meals.

Mr. PARK. Yes, sir.

Senator CHAFEE. So I think the situation is a little different. Now did you say, is there an exception in the meals situation as it pertains to meals provided by restaurants and caterers are fully deductible? You indicate that in your statement.

Mr. PARK. Senator, I have a statement that I would like to read in that connection. It says "Section 142 of the Act contains several exceptions."

For instance, "The expenses of food and beverages incurred as an integral part of a convention, seminar, or other qualified meeting are fully deductible." And it cites the Code.

"The percentage reduction rule also does not apply to a restaurant or a catering firm which may deduct 100 percent of its costs for food and beverage items purchased in connection with preparing and providing meals to its paying customers that are consumed at the work site by employees of the restaurant or caterer." So I believe that that answers it.

Senator CHAFEE. Well that is nice helpful information to have on your side.

Mr. Merski, I think one of the good points you make is when you refer to the international competitiveness situation, how it affects you folks that way. So we will do our best to straighten these out. I want to thank each of you for coming.

Mr. MERSKI. We appreciate your consideration.

Mr. PARK. Mr. Chairman, may I add one statement in connection with your question to me about firemen? I am slow on my feet, but it occurs to me that with minor exceptions, firemen are public employees and, therefore, profit and loss is not a factor and income tax statements are not made.

Senator CHAFEE. Also, firemen can go down the street. An employee on a drilling barge has to really be a water walker to find a nearby restaurant.

Senator BAUCUS. Thank you all very much. You have been very helpful and we will make all the changes we can. Thank you. The committee is adjourned.

[Whereupon, at 12:14 p.m., the hearing was concluded.]

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

STATEMENT OF SENATOR DENNIS DECONCINI

BEFORE

THE SENATE FINANCE COMMITTEE

Mr. Chairman, I want to thank you for the opportunity to present testimony to this Committee on S. 1350, The Technical Corrections Act of 1987.

I want to bring to your attention a matter that became apparent only after the Conference Report on last year's tax bill was filed. That matter has not been dealt with in The Technical Corrections Act, but it needs to be addressed. It relates to the effective date of the new installment sales provision adopted in the Tax Reform Act of 1986.

Section 811 of the Tax Reform Act amended Section 453C of the Internal Revenue Code and created a new disproportionate disallowance rule for installment sales. The Senate provision for this new rule was adopted in the Conference Report. As stated in the Conference Report: "The conference agreement generally follows the Senate amendment with certain modifications." (Tax Reform Act of 1986, H.Report 99-841, Vol. II, p. 297.)

Each of the modifications made by the conferees to the Senate provision was specified in the Conference Report. None related to the effective date. The Senate provision was unequivocal in stating that the new installment sales rule would have an effective date of taxable years "beginning after December 31, 1986." However, in the final language of the Conference Report to the 1986 Act, the effective date for that new provision was changed to "taxable years ending after December 31, 1986." (Section 811 (c) (1))

It is my understanding that this word change was made at the eleventh hour by staff without consultation or discussion. Further, it is my understanding that the change was made because of a previous error in calculating the original revenue estimates of the Senate installment sales provision.

Mr. Chairman, this Committee and the entire Congress was clearly very concerned with the revenue considerations associated with all tax legislation. However, we cannot allow those considerations to take precedence over regular legislative procedure and fairness--particularly in such cases as this one in which the revenue implications are relatively minor.

In my view, the change made in the effective date is inequitable. I therefore have introduced S. 1197, which would reinstate the original wording.

The substitution of the word "ending" for "beginning" in the effective date significantly changed the operation of the new installment sales provision on fiscal year taxpayers. I have been advised by a number of taxpayers who happen to have a taxable year other than a calendar year that the new rule will affect them in a much different, and far more adverse, way than on calendar year taxpayers.

In a colloquy I had with Senator Packwood during the floor debate on the Conference Report on the Tax Reform Act, he affirmed that there was no intention or explicit decision by the conferees to treat certain taxpayers differently under this new rule simply because they were not calendar year taxpayers. A copy of that colloquy is attached.

Moreover, there was concern raised by the conferees regarding the immediate impact that the new installment sales rule would have on many taxpayers. The conferees therefore adopted a transition rule which was specifically designed to allow those taxpayers who had been using the installment sales method, particularly homebuilders, time to adjust to the new rule.

The word change I have noted in the effective date went directly against the intent of this transition rule, since it accelerated by up to a year the date on which the new rule would apply to fiscal year taxpayers. For example, the word change meant that the new provision began acting on a taxpayer with a fiscal year ending January 31, nearly ten months before the Tax Reform Act was even signed into law.

I would therefore urge that S. 1350 be amended to reinstate the effective date of the new installment sales provision enacted in the 1986 Tax Reform Act to fiscal years <u>beginning</u> after December 31, 1986. That was the date that was included in the Senate bill, and that I believe the conferees had intended to be included in the final Conference Report.

GORDON J. HUMPHREY
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United States Senate
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**STATEMENT OF SENATOR GORDON J. HUMPHREY
ON S.1350, THE TECHNICAL CORRECTIONS ACT OF 1987**

**ADOPTION EXPENSES TRANSITION PERIOD SHOULD BE INCLUDED IN
THE TECHNICAL CORRECTIONS BILL**

MR. CHAIRMAN, ONE OF THE GREAT ACCOMPLISHMENTS OF THE 99TH CONGRESS WAS THE TAX REFORM BILL. I STRONGLY SUPPORTED TAX REFORM. HOWEVER, I HAVE SERIOUS CONCERNS ABOUT ONE PROVISION WHICH, IF NOT ADDRESSED, WILL ADVERSELY AFFECT ADOPTIVE PARENTS AND THE MOVEMENT OF CHILDREN OUT OF THE FOSTER CARE SYSTEM AND INTO PERMANENT HOMES.

ACCORDING TO THE DEPARTMENT OF HEALTH AND HUMAN SERIVCES, AN ESTIMATED 276,000 CHILDREN ARE IN FOSTER CARE, AT LEAST 36,000 OF WHOM ARE LEGALLY FREE AND WAITING FOR ADOPTIVE HOMES. MANY ARE CHILDREN WITH SPECIAL NEEDS, THAT IS, CHILDREN WHO ARE OLDER, IN SIBLING GROUPS, PHYSICALLY OR EMOTIONALLY DISABLED, OR MEMBERS OF MINORITY GROUPS.

CONGRESS HAS RECOGNIZED THE NEED TO ENCOURAGE AND REDUCE THE FINANCIAL BURDEN ASSOCIATED WITH THE ADOPTION OF CHILDREN WITH SPECIAL NEEDS. UNTIL JANUARY OF THIS YEAR, THAT WAS ACCOMPLISHED, IN PART, THROUGH A MODEST $1500 TAX DEDUCTION. THE TAX REFORM ACT OF 1986 REPEALED THIS DEDUCTION AND REPLACED IT WITH A NEW ENTITLEMENT PROGRAM UNDER TITLE IV-E OF THE SOCIAL SECURITY ACT, WHICH WOULD ALLOW STATES TO REIMBURSE DIRECTLY FAMILIES WHO ADOPT THESE CHILDREN FOR SOME OR ALL OF THEIR EXPENSES.

UNFORTUNATELY, WHILE ADOPTIVE PARENTS HAVE LOST THE TAX DEDUCTION, THE NEW REIMBURSEMENT SYSTEM IS A LONG WAY FROM BEING IN PLACE. IT IS NOT CLEAR WHEN HHS WILL PROMULGATE THE FINAL REGULATIONS. UNFORTUNATELY, THE TAX REFORM ACT CONTAINED NO PROVISION FOR A TRANSITIONAL PERIOD TO ALLOW THE FEDERAL GOVERNMENT, STATE TITLE IV-E ADOPTION AGENCIES, AND PRIVATE ADOPTION AGENCIES TIME TO WORK OUT PROCEDURES TO IMPLEMENT THE DIRECT PAY SYSTEM.

THE DELAYS IN IMPLEMENTING THIS PROGRAM MIGHT PREVENT ELIGIBLE PARENTS FROM RECEIVING THE BENEFITS THEY NEED IN A TIMELY FASHION, AND THUS DISCOURAGE ADOPTION. I FEEL WE NEED TO AVOID THIS. ON THE FIRST DAY OF THIS CONGRESS, I INTRODUCED S. 270, TO PROVIDE FOR A TRANSITION PERIOD FOR THE DIRECT REIMBURSEMENT PROGRAM. THIS MEASURE READS SIMPLY:

"THE AMENDMENTS MADE BY SECTION 135 SHALL APPLY TO TAXABLE YEARS BEGINNING AFTER DECEMBER 31 OF THE CALENDAR YEAR IN WHICH FINAL REGULATIONS ARE ISSUED TO IMPLEMENT THE REIMBURSEMENT OF NONRECURRING ADOPTION EXPENSES UNDER ANY ADOPTION ASSISTANCE AGREEMENT UNDER SUBTITLE E OF THE TITLE IV OF THE SOCIAL SECURITY ACT.

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NO DEDUCTION SHALL BE ALLOWED WITH RESPECT TO AMOUNTS PAID FOR ADOPTION EXPENSES DIRECTLY RELATED TO THE LEGAL ADOPTION OF A CHILD WITH SPECIAL NEEDS UNDER SECTION 222 OF THE INTERNAL REVENUE CODE OF 1986 TO ANY TAXPAYER RECEIVING REIMBURSEMENT FOR SUCH AMOUNTS UNDER ANY ADOPTION ASSISTANCE AGREEMENT UNDER SUBTITLE E OF TITLE IV OF THE SOCIAL SECURITY ACT."

THE ADOPTIVE PARENTS ENTITLED TO THIS REIMBURSEMENT ARE THE INDIVIDUALS AND COUPLES WHO GIVE PERMANENT HOMES TO CHILDREN WHO NEED IT THE MOST. THEY ARE PEOPLE WHO ARE WILLING TO TAKE ON LARGE RESPONSIBILITIES IN ORDER TO BUILD A FAMILY AND BRING JOY TO A CHILD WHO NEEDS A HOME.

MR. CHAIRMAN, I KNOW OF YOUR SPECIAL COMMITMENT TO THE PROMOTION OF ADOPTION. I URGE YOU AND THE COMMITTEE TO ASSIST SPECIAL NEEDS ADOPTIONS BY ADDING THE TEXT OF S. 270 TO S. 1350.

II

100TH CONGRESS
1ST SESSION

S. 270

To provide a transition period for the full implementation of the nonrecurring adoption expenses reimbursement program.

IN THE SENATE OF THE UNITED STATES

JANUARY 6, 1987

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

---

A BILL

To provide a transition period for the full implementation of the nonrecurring adoption expenses reimbursement program.

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

SECTION 1. TRANSITION PERIOD FOR FULL IMPLEMENTATION OF NONRECURRING ADOPTION EXPENSES REIMBURSEMENT PROGRAM.

(a) IN GENERAL.—Section 151 of the Tax Reform Act of 1986 (relating to effective dates) is amended by adding at the end thereof the following new subsection:

"(f) ADOPTION EXPENSES.—

"(1) IN GENERAL.—The amendments made by section 135 shall apply to taxable years beginning after December 31 of the calendar year in which final regulations are issued to implement the reimbursement of nonrecurring adoption expenses under any adoption assistance agreement under subtitle E of title IV of the Social Security Act.

"(2) DENIAL OF DOUBLE BENEFIT.—No deduction shall be allowed with respect to amounts paid for adoption expenses directly related to the legal adoption of a child with special needs under section 222 of the Internal Revenue Code of 1986 to any taxpayer receiving reimbursement for such amounts under any adoption assistance agreement under subtitle E of title IV of the Social Security Act.".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect as if included in section 151 of the Tax Reform Act of 1986.

Albright College
Planned Giving

Gentlemen: July 17, 1987

On behalf of Albright College in Reading, Pennsylvania, I am writing to express my deep concern over learning that the Tax Reform Act of 1986 may have inadvertently or otherwise placed in jeopardy the charitable gift annuity as a valid instrument of charitable giving, as opposed to a form of commercial-type insurance.

Albright College is a 131 year old liberal arts college founded by the Methodist Church, which until the 1950's included a seminary for post graduate ministerial students. Traditionally, our older alumni became ministers, social workers, or educators. As a result, our alumni do not boast great wealth, but they have a true dedication to the principles embodied in the education they received at Albright.

The charitable gift annuity has been an extremely important vehicle whereby they could give in support of the institution they valued, but without risking the loss of needed income from limited resources at a time in their lives when the future constantly poses risks to their well-being. These people do not enter into an annuity agreement with Albright because they are seeking commercial-type insurance; they enter into a charitable gift which gives them great satisfaction while they are still living but which addresses their vulnerability.

At Albright we allow several members of one family, for instance, to purchase gift annuities and we then "pool" their remainder interests to create a current scholarship. The scholarship money is actually coming from our own unfunded student aid, but we simply put a name around a certain portion of it until the family members die, at which time their scholarship becomes funded by their gift annuity remainders and becomes part of the permanent endowment of the college.

I can't tell you how much it has meant to alumni who have only 5 or $10,000 to part with to see it create scholarship assistance while they are living to students they can meet at the annual donor/student dinner. These small gift annuities are essential for enabling small donors to experience the satisfaction of charitable giving. They are no different technically than the arrangement with a large donor for a charitable annuity trust, except that they are more protective of the small donor by being backed by the assets of the college.

<u>I urge you to please amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec.501(c)(3) organizations are not "commercial-type insurance" under IRC Sec.501(m).</u>

Please do not take away an important source of funds for institutions such as Albright and many others who rely on the charitable giving of small donors but dedicated ones, who can enjoy the sense of philanthropy and stewardship of their money made available through charitable gift annuities.

Sincerely,

Patricia N. Moulton

Patricia N. Moulton
Director of Planned Giving
Albright College
P.O.Box 15234
Reading, PA 19612-5234

AKIN, GUMP, STRAUSS, HAUER & FELD

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July 24, 1987

William Wilkins
Chief Counsel
Committee on Finance
United States Senate
205 Dirksen Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987

Dear Bill:

We appreciate the opportunity to provide our comments on the Technical Corrections Act of 1987. We are commenting on the proposed corrections to sections 501(c)(25) and 514(c)(9) contained in the Technical Corrections Act of 1987 (H.2636, S.1350).

As more fully discussed in the enclosed summaries, the technical corrections as proposed would virtually repeal the Congressional intent to extend the benefits of the section 514(c)(9) exemption from the debt financed property rules to tax-exempt section 501(c)(3) organizations that invest through section 501(c)(25) entities and would impose an unduly narrow definition of the class of property a Section 501(c)(25) entity may hold. In addition, the proposed technical corrections would impose a substantive change by extending a special provision relating to the tax treatment of mortgages held by partnerships to all exemptions under the debt financed property rules.

We welcome the opportunity to discuss this issue with your staff.

Very truly yours,

David W. Hardee, P.C.
Lawrence J. Hass

THE TECHNICAL CORRECTIONS ACT SHOULD NOT NEGATE THE PURPOSE OF SECTION 501(c)(25)

The Tax Reform Act of 1986 added section 501(c)(25) to the Code. Section 501(c)(25) describes a new category of tax-exempt corporations or trusts organized for the exclusive purposes of acquiring and holding title to real property, and collecting and remitting the income (less expenses) from such property to their shareholders or beneficiaries. The Act also added section 501(c)(25) entities to the list of section 514(c)(9) qualified organizations entitled to acquire debt-financed real property without subjecting themselves to the unrelated business income tax.

Section 501(c)(25) was added to the Code in 1986 in order to permit pension funds and tax-exempt educational institutions to invest indirectly in interests in real property through a title-holding corporation under the same terms as they could invest directly. Under certain circumstances, these entities could already pool their investments and obtain the same benefits under section 514(c)(9) as if they had invested directly. Section

501(c)(25) provides a safe harbor with the additional benefit of limited liability. Unlike section 501(c)(2) title-holding entities, a section 501(c)(25) entity permits pooling of investments by unrelated parties and an exemption from taxation of leveraged investments.

In addition, section 501(c)(25) permits certain organizations to do indirectly what they cannot do directly. Thus, under section 501(c)(25), tax-exempt foundations and other section 501(c)(3) organizations may indirectly invest in leveraged real estate without deriving taxable debt-financed income. If they were to acquire leveraged real property directly, however, their income would be partly taxable. Prior to the 1986 Act, foundations had certain distinct disadvantages vis-a-vis pension funds, colleges and universities. First, foundations generally have smaller investment portfolios and are unable to make large real estate investments on their own while prudently diversifying their portfolio. Second, since foundations are unable to make leveraged acquisitions of real property without incurring an income tax, they are often unable to compete with pension funds, colleges and universities in bidding for property, especially that which is already subject to debt. Third, this differing tax treatment means that foundations and pension funds generally are unable to pool their investments. The addition of section 501(c)(25) of the Code and its inclusion in the list of organizations entitled to exemptions from the debt financed property rules under section 514(c)(9) of the 1986 Act was designed to rectify these problems.

Section 116 of the Technical Corrections Act of 1987 (S. 1350, H. 2636) ("TCA") would for all practical purposes repeal Code section 501(c)(25). Three changes proposed by the TCA would eliminate the advantages that Congress, after careful consideration, provided in the form of section 501(c)(25) organizations:

1. The TCA would impose an unduly narrow definition of the class of property a section 501(c)(25) entity may hold. Not only would it exclude direct interests in real property (such as tenancies in common), and interests in other section 501(c)(25) entities, it would also exclude almost all indirect investments, such as interests in joint ventures, that hold only real property. A primary purpose of section 501(c)(25) was to permit eligible entities to do indirectly what they already could do directly. Accordingly, rather than restricting the class of investments that may be made, the definition of interests in real property under section 501(c)(25) should be made consistent with the definition utilized by REITs, thereby including joint ventures (if the property held by such venture qualifies), certain leases, mortgages, and temporary investments of cash after received from shareholders, and prior to their investment. The narrow definition of real property in the TCA makes a section 501(c)(25) entity unworkable such as when the entity diversifies its portfolio through joint venture investments or when it sells one of its properties by providing seller financing; removing mortgages from the class of eligible real property precludes providing seller financing with a favorable return. Potential abuse situations may be prohibited within the context of technical amendments.

2. Contrary to a primary purpose of the statute, the TCA would eliminate the exemption under section 514(c)(9) for tax-exempt foundations by treating a section 501(c)(25) entity as a pass-through entity under the debt-financed property rules. This is contrary to Congress' decision to permit such entities to invest indirectly in a manner they are not permitted to do directly. This amendment would prevent foundations from investing with pension funds, colleges and universities due to the differing abilities of each type of organization to utilize leverage in real estate investments. Those entities eligible to make leveraged investments will invest through joint ventures rather than subject themselves to the additional restrictions imposed by section 501(c)(25).

3. The TCA would extend a special provision relating to the tax treatment of mortgages held by partnerships to all of the exemptions under the debt-financed property rules. This mortgage exception was enacted for a limited purpose and should not be blindly extended without further consideration of the consequences, especially since other real estate entities under the Code, such as REITs and REMICs, classify mortgages as interests in real property. Such an amendment constitutes a substantive change that should not be enacted without full analysis and discussion of the consequences.

SECTION 501(c)(25) ENTITIES SHOULD BE PERMITTED TO HOLD DIRECT AND INDIRECT INTERESTS IN REAL PROPERTY

Section 501(c)(2) of the Code has long provided a tax exemption for a corporation organized to hold title to property, and to distribute the income therefrom to one or more related tax exempt organizations. However, the IRS did not permit such a title-holding company to be exempt if two or more of its parent organizations were unrelated. The Tax Reform Act of 1986 added a new category of exempt organizations under section 501(c)(25) to permit certain unrelated exempt organizations to jointly utilize one title-holding company for real property investments. The primary purpose of the legislation was to permit pension funds and certain tax-exempt educational institutions to do indirectly what they could do directly, along with permitting other section 501(c)(3) organizations to do indirectly what they could not do directly. These joint investment vehicles provide the advantages of investment diversification and economies of scale for each of the parent tax-exempt organizations that are unavailable in direct unilateral property investments.

The amendments to section 501(c)(25) proposed by section 116 of the Technical Corrections Act of 1987 ("TCA") would negate the Congressional purpose underlying section 501(c)(25) by placing unnecessary restrictions on the type of real property investments that such an entity can hold. These amendments are also inconsistent with the class of real property investments Congress permitted for other entities, such as REITs and REMICs, and which tax-exempt organizations currently may hold directly. For example, the TCA would not permit ownership of property by tenancy in common (or similar interest), or through such intermediary investment vehicles as partnerships, trusts, or even another 501(c)(25) entity, even if that entity holds only fee simple interests in real property. Finally, pension trusts presently can make such indirect pooled investments through group trusts under Revenue Ruling 81-100, 1981-1 C.B. 326, without losing the advantages of Section 514(c)(9) or the ability to invest in joint ventures.

These prohibitions proposed by the TCA are unnecessary and inconsistent with the purpose of section 501(c)(25). First, a tenancy in common is a direct interest in real property. Second, permitting a 501(c)(25) entity to hold interests in another 501(c)(25) entity fulfills the policy goal of permitting the tax-exempt beneficial owners to pool their dollars and diversify their risk, while limiting the class of investors to tax-exempt entities. This tiering of 501(c)(25) entities should be permitted, probably with a limit of 35 on the number of ultimate beneficial owners of all section 501(c)(25) entities with an equity interest in the property.

Since section 501(c)(25) was intended to expand the availability of a section 501(c)(2)-type entity for real property investments by exempt organizations, it should incorporate as its definition of "real property" the class of "real estate" assets set forth in section 856(c)(6)(B) of the Code. The term "real estate assets" such as fee and co-ownership of land or improvements, leaseholds and options on land and improvements, and interests in other REITs or in REMICs, and certain temporary investment income for up to one year prior to its investment in real property, includes interests in mortgages on real property. Section 1.856-3(g) of the Treasury Regulations provides that partnership assets flow through, thereby enabling a REIT to hold partnership interests if the partnership holds permissible assets. Similarly, Code section 512(c) and the Treasury regulations promulgated thereunder provide that in determining the unrelated business taxable income of a tax-exempt partner, the partner's pro rata share of the partnership's items flow through as if held directly. These provisions should apply to section 501(c)(25) entities to create consistency in the law.

PRESERVE THE ABILITY OF 501(c)(3) ENTITIES TO MAKE LEVERAGED REAL PROPERTY INVESTMENTS THROUGH 501(c)(25) ENTITIES

The Tax Reform Act of 1986 added section 501(c)(25) to the Code. Section 501(c)(25) describes a new category of tax-exempt corporations or trusts organized for the exclusive purposes of acquiring and holding title to real property, and collecting and remitting the income (less expenses) from such property to their shareholders or beneficiaries. The Act also added section 501(c)(25) entities to the list of section 514(c)(9) qualified organizations entitled to acquire debt-financed real property without deriving unrelated business taxable income.

Under the Act, only governments, governmental and qualified pension plans, section 501(c)(3) organizations and other 501(c)(25) entities may be shareholders or beneficiaries of a section 501(c)(25) entity. Of these entities, only section 501(c)(3) organizations (with the exception of exempt educational institutions) would have taxable debt-financed income under section 514 if they acquired real property with debt financing. Thus, section 501(c)(25) permits these entities to invest indirectly in real property in a more advantageous manner than they can directly, provided they abide by the other restrictions of section 501(c)(25).

Section 116 of the Technical Corrections Act of 1987 would treat section 501(c)(25) organizations as pass-through entities for purposes of the section 514(c)(9) exemption to the debt-financed property rules. As a result, section 501(c)(3) organizations (other than educational institutions) investing in a section 501(c)(25) entity would have taxable income if the 501(c)(25) entity makes leveraged real property investments.

The proposed amendment would emasculate section 501(c)(25) and contradict its reason for being. In their introductory statements, the sponsors of the section 501(c)(25) provisions, Senator Wallop and Representative Matsui, both made clear that their legislation would permit private foundations and charities to invest indirectly in leveraged real property through a section 501(c)(25) entity without being liable for taxes. In addition to permitting qualified pension plans and certain tax-exempt educational institutions to invest indirectly under terms comparable to a direct investment, Congress wanted to permit section 501(c)(3) tax-exempt organizations to be able to participate in real estate investment opportunities jointly with pension funds. In testimony before the House Ways and Means Select Revenue Measures Subcommittee, the Treasury Department acknowledged and supported this goal of the legislation. In fact, to promote consistency, Treasury recommended permitting section 501(c)(3) entities to invest in leveraged real property on the same terms as pension funds without an intervening section 501(c)(25) entity. Congress, recognizing this disparity, nonetheless decided to limit the exemption for leveraged real property investments by a section 501(c)(3) entity to those investments made thorugh a section 501(c)(25) entity.

Were this amendment to be adopted, most section 501(c)(3) entities would again be unfairly disadvantaged in investing their endowments in interests in real properties. When Treasury and both tax writing committees have acknowledged and endorsed a policy which is clearly reflected in the statute, it should not be undone by a provision buried in the Technical Corrections Act. Although consistency of treatment for direct and indirect investments may be a laudable goal, Congress consciously decided to permit section 501(c)(3) entities to invest in leveraged real property without deriving taxable income only if they invest through a section 501(c)(25) entity. Congress should delete this Amendment.

SECTION 514(c)(9) SHOULD NOT BE AMENDED TO PREVENT TREATMENT OF AN INTEREST IN A MORTGAGE AS REAL PROPERTY

Section 514(c)(9) generally exempts from the definition of acquisition indebtedness, indebtedness incurred by certain tax-exempt "qualified organizations" (pension plans, educational institutions and section 501(c)(25) entities) from their real property investments. When the leveraged property is held by a partnership composed of both "qualified organizations" and organizations that are not qualified, however, the section 514(c)(9) exemption does not apply if the principal purpose of any allocation of partnership items is the avoidance of federal income tax. Section 514(c)(9)(B)(vi).

The Tax Reform Act of 1986 amended section 514(c)(9)(B)(vi) by adding the "principal purpose" test for partnerships that include nonqualified organizations, and including the sentence "an interest in a mortgage shall in no event be treated as real property". The principal purpose test was added because the qualified allocation requirement of prior law section 168(j)(9) sometimes conflicted with the "substantial economic effect" requirement of Code section 704(b).

Section 116(a)(6) of the recently introduced Technical Corrections Act of 1987 (the "TCA") would extend this new provision in section 514(c)(9)(B)(vi) prohibiting the treatment of an interest in a mortgage as real property, to all of section 514(c)(9), not merely to clause (vi) of subparagraph (B). No explanation has been offered for making this change.

This change would have a number of deleterious substantive effects. First, it would tend to negate the ability to use section 501(c)(25) organizations. For example, a section 501(c)(25) entity may have been created as a ten-year closed-end fund. If the organization sells one of its properties in year five and takes back a note secured by a short-term mortgage on the property, the section 501(c)(25) entity would be disqualified because it held a mortgage and, therefore, did not exclusively hold real property. These consequences would result even if the seller financing represents the most advantageous sale terms available and payments on the note would be reinvested in other real property. This would again have the effect of forcing the use of group trusts or other forms of investment besides section 501(c)(25) entities, with discriminatory effects as to which type of qualified organizations can pool their funds in making real estate investments.

The term "real property" has well-understood meanings, which often include interests in mortgages secured by real property. For example, the REIT provisions of the Code (section 856 et seq.) include mortgages in the definition of "interests in real property" under section 856(c). Given the specific concern underlying this limited "mortgage as real property" provision, and the broad definition of real property elsewhere in the Code, section 116(a)(6) of the TCA should not be adopted as a mere technical correction.

David M. Farmer
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July 16, 1987

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
1111 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Bill - H.R. 2636 - S. 1350
Related Person Insurance Income - Election

Dear Mr. Leonard:

The Alliance of American Insurers believes that Section 112(h)(1) of H.R. 2636 misconstrues the intent of Congress with respect to the election provided in section 953(c)(3)(C) of the Internal Revenue Code. The Alliance is a trade association of over 175 property/casualty insurance companies that do business in all 50 states and the District of Columbia. We urge that section 112(h)(1) be revised to provide that this election is available with respect to U.S. shareholders to whom subpart F income is attributed solely because of the revisions to section 953 in the 1986 Tax Reform Act.

The 1986 Act expanded the definition of "U.S. shareholder" with respect to offshore insurance companies to include any U.S. person owning any stock in an offshore insurer (or, in the case of mutual companies, any U.S. policyholder with the right to vote). The definition of "controlled foreign corporation" ("CFC") was also revised so that, if such an offshore insurer is 25% or more owned by U.S. shareholders, subpart F income is attributed to such shareholders in the taxable year in which it is earned by the company. In section 953(c)(3)(C), Congress provided an election to mitigate the harshness of this rule. If the offshore insurer elects to treat all of its insurance income as effectively connected with a U.S. business, it is taxed as though that income was U.S. income and subpart F income is not attributed to the U.S. shareholders. There is no requirement in the 1986 Act or the conference report on H.R. 3636 that the offshore insurer must not be a CFC without application of the 1986 Act's provisions in order to be eligible for this election.

Section 112(h)(1) of H.R. 2636 would deny this election to an offshore insurer that was or becomes in the future a CFC under the rules prior to the 1986 Act. The Joint Committee on Taxation's staff explained that this provision is

> "to make it clear that the election is not available to a corporation that is a controlled foreign corporation without applying the special subpart F rules for captive insurance companies... Thus, the bill clarifies that the election is available only in situations where a foreign corporation and its shareholders are subject to subpart F treatment by virtue of the Act's special captive insurance rules, and not where subpart F treatment results from application of the rules that are generally applicable outside the captive insurance context." Description of the Technical Corrections Act of 1986, Joint Committee on Taxation, June 15, 1987, pp. 198-199 (emphasis added).

It would appear that Congress intended to allow the election with respect to shareholders who would not be subject to subpart F treatment under prior law, while denying it to those who would be subject to subpart F.

Unfortunately, section 112(h)(1) does not conform to this intent in the case where an offshore insurer was a CFC under pre-1986 Act rules but most of the U.S. participants were not "U.S. shareholders" subject to subpart F attribution. For instance, at least one U.S. insurer has arranged for the establishment of an offshore mutual insurance company. This U.S. insurer holds reserve certificates that entitle it to 40% of the voting power of the offshore company, with the remaining 60% divided among the offshore company's policyholders, which are U.S. persons but who were not "U.S. shareholders" under the old rules. Subpart F income was and is attributed to the U.S. insurer, which has always been a "U.S. shareholder". Under the 1986 Act, however, the U.S. policyholders also become "U.S. shareholders", and subpart F income is attributed to them as well. Since, as the Joint Committee staff stated, it was the intent of Congress to provide the section 953(c)(3)(C) election to shareholders of a foreign corporation who were not subject to the subpart F rules under prior law, we believe that election ought to be available with respect to those U.S. shareholders.

We believe that section 112(h)(1)(A) should be deleted and replaced with the following language:

> "Any election under this subparagraph shall not apply to related person insurance income which (determined without reference to this subsection) constitutes insurance income includable in the gross income of one or more United States shareholders under sections 951(a)(1)(A)(i) and 952(a)(1)."

This language denies the benefit of the election to any person to whom subpart F income was attributed before the 1986 Act revisions (including the U.S. insurer in the example above), while providing the election with respect to persons who would not be U.S. shareholders without the application of the 1986 Act. Section 112(h)(1)(B) of H.R. 2636 would then be unnecessary, and should also be deleted.

We believe that these changes are non-controversial clarifications of the Congress' intent, and we urge their adoption in H.R. 2636 and S. 1350.

Sincerely,

Stephen W. Broadie
Senior Counsel - Taxation and Finance

American Association
of Equipment Lessors

July 25, 1987

Mary McAuliffe, Esquire
Minority Chief of Staff
Senate Finance Committee
Senate Dirksen Office Building
Room 205
Washington, D.C. 20510

HAND DELIVERED

Re: Technical Corrections Act §102(c)(2)
mid-quarter convention- operation of 40% test

Dear Ms. McAuliffe:

Taxpayers including several equipment lessors already have placed certain property in service early in 1987 so as to avoid the operation of the mid-quarter convention for depreciation. The Technical Corrections Act §102(c)(2) would radically alter the operation of the 40% test that triggers application of the mid-quarter convention. We respectfully request that §102(c)(2) of the bill be deleted or modified, as explained in the attached memorandum, to avoid unfairness to these taxpayers and prevent disruption of the business community.

Thank you for considering our views on this important technical issue.

Yours very truly,

Michael J. Fleming
President, AAEL

MEMORANDUM

Re: Technical Corrections Act of 1987 §102(c)(2):
mid-quarter convention- operation of 40% test

Technical Corrections Act §102(c)(2) (H.R.2636 and S.1350), if enacted, would radically alter the operation of the 40 percent test that triggers application of the mid-quarter convention in the depreciation rules. This memorandum by the American Association of Equipment Lessors (AAEL) respectfully requests that proposed §102(c)(2) be modified or deleted.

Ordinarily, under the Tax Reform Act of 1986, a half-year convention applies to first year and last-year allowances for depreciable personal property. Yet under Code §168(d)(3), if a taxpayer in any taxable year places more than 40% of its applicable property in service in the last quarter, a mid-quarter convention will apply to determine the cost-recovery allowances for all such property. This mid-quarter convention treats all property placed in service during any quarter of a taxable year as placed in service on the midpoint of such quarter. Section 203(d)(3) of the 1986 Act contains a special rule that requires the taxpayer to take transition ACRS property into account in applying the 40% test. If the mid-quarter convention applies, however, it applies only with respect to new law property. The mid-quarter convention does not apply to reduce the depreciation on transition ACRS property. See H.R.(Conf) Rept.99-841 p.II-47 (1986).

The technical correction proposed in §102(c)(2) of the bill would eliminate transition ACRS property from the 40% calculation for taxable years beginning on or after January 1, 1987. The statutory language from §203(d) of the Tax Reform Act of 1986, with underscored language showing the proposed technical amendment, is this:

> "(d) MID-QUARTER CONVENTION.-- In the case of any taxable year <u>beginning before 1987</u> in which property to which the amendments made by section 201 do not apply is placed in service, such property shall be taken into account in determining whether section 168(d)(3) of the Internal Revenue Code of 1986 (as amended by section 201) applies for such taxable year to property to which such amendments apply. <u>The preceding sentence shall apply only to property which would be taken into account if such amendments did apply</u>."

The only purpose of this proposed technical amendment, apparently, is to clarify the application of the mid-quarter convention to certain elective property placed in service during the last 5 months of 1986. <u>See</u> Joint Committee on Taxation's "Description of the Technical Corrections Act of 1987" p.12 (June 15, 1987). But the proposed technical amendment also has other harsh (and possibly unintended) effects.

Two examples illustrate the impact of the proposed technical amendment that concerns us.

> <u>Example 1</u>. A calendar year taxpayer places $70 of transition ACRS property in service in January 1987 and places $30 of new law property in service in November 1987. Under existing law the mid-quarter convention does not apply to any of this property. Technical Corrections Act §102(c)(2) would cause the mid-quarter convention to apply to the new law property.

> <u>Example 2</u>. A calendar year taxpayer places $30 of new law property in service in January 1987 and places $70 of transition ACRS property in service in November 1987. Under existing law the mid-quarter convention applies to the new law property. Technical Correction Act §102(c)-(2) would cause the mid-quarter convention to be inapplicable.

The outcome illustrated by Example 1, under the proposed technical amendment, would unfairly penalize taxpayers (including several equipment leasing companies) who already have placed transition ACRS property in service. Relying on current law, these taxpayers placed such property in service early in 1987, and made commitments and plans to place some new property in service late in 1987, with the reasonable expectation of avoiding the mid-quarter convention. The outcome illustrated by Example 2 also penalizes the taxpayer who made deliveries, commitments and plans for placed-in-service dates in reasonable reliance on current law, since depreciation on the new law property already placed in service in January 1987 (which would qualify for 10½ months depreciation under existing law) would be cut back to 6 months under the proposed technical amendment. Moreover, as illustrated by both Example 1 and Example 2, the change of law threatened by the technical amendment (and the uncertainty created by this threatened change) are disruptive to reasonable tax planning by businessmen.

To avoid this sort of unfairness and disruption, AAEL suggests that §102(c)(2) of the technical corrections bill be deleted. Alternatively, proposed §102(c)(2) might to changed so that it applied only in "the case of any taxable year beginning before <u>1989</u>" (instead of 1987), so as to give taxpayers time to adjust their scheduled placed-in-service dates to the new proposed law.

July 25, 1987

STATEMENT
OF THE
AMERICAN BANKERS ASSOCIATION
TRUST DIVISION

A. Section 108(e) of the Bill; Common Trust Funds and Taxable Years

As stated in the Joint Committee on Taxation Description of H.R. 2636, the Tax Reform Act of 1986 did not change the taxable year to be used by a common trust fund taxed under IRC Sec. 584. Section 108(e) would amend IRC Sec. 584 by adding a new subsection (h) requiring that the taxable year of such a fund be the calendar year and making this change effective for 1987. The ABA urges that this change not be made effective until 1988. Certain steps are required in order for a common trust fund to change its reporting period, including (1) securing the approval of the bank's board of directors, (2) securing the approval of the Comptroller of the Currency, (3) securing the approval of the Internal Revenue Service and (4) giving notice of the change to co-fiduciaries and others at least a stated period before its effective date. Also, computer programs for common trust funds must be changed for 1987 and this cannot be done in a short period of time. The Act will in all likelihood not be passed before October 1987. The time remaining in 1987 to complete the actions required to change common trust funds from fiscal years to a calendar year will not be sufficient to get the job done in 1987.

Congress should not pass laws which cannot be complied with in the time period given. Further, the ABA does not believe any revenue loss would result from delaying the change until 1988 because it believes the revenue estimates for 1987 did not include any amount for requiring a common trust fund to use a calendar year.

B. Section 101(e) of the Bill; Deductions for Costs of Administration of Trusts and Estates

This provision would amend the last sentence of IRC Sec. 67(c) to authorize regulations whereby deductions of a trust or an estate will not be taken out of the 2 percent floor rule. The present last sentence of IRC Sec. 67(c) does not authorize such regulations and would therefore not disallow any indirect deduction through a trust or an estate. The Description prepared by the Staff of the Joint Committee on Taxation in explaining the change states (p. 7) that regulations could "apply the 2 percent floor at the beneficiary level rather than at the entity level, to the extent that income is distributed to beneficiaries." The ABA believes the change is not clarifying but rather is substantive and, as such, does not belong in a technical amendments act.

C. Section 111A(f) of the Bill; Tax on Excess Retirement Accumulation

An election would be provided to permit a spouse of an individual who "is the beneficiary of all of the interests" in qualified plans to have the excess distribution rule apply instead of having a supplemental estate tax imposed on the excess retirement accumulation. The statutory language is unclear whether the election may be made when the beneficiary is a trust but the spouse is the sole beneficiary of the trust, as would be the case with an IRC Sec. 2056(b)(5) trust. The ABA recommends that the statutory language be changed to clarify that an election be made when the spouse is the sole beneficiary of a trust named to receive the plan proceeds.

D. Section 114(b) of the Bill; Special Rule for Reversionary Interest

IRC Sec. 673 would be amended by the addition of a new subsection (c) stating that for purposes of subsection (a) the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of the grantor. This is a substantive change which should be effective only for transfers made after June 10, 1987.

E. Section 114(f) and (g) of the Bill; the GST Tax

In general, the ABA believes the proposed changes relating to the generation-skipping transfer tax imposed by Chapter 13 of the Code are helpful. However, as discussed below, (1) two of these changes (see items 2b and 5) are not designed to "correct or clarify" but rather are substantive changes which as such should be rejected as being inconsistent with the purpose of a Technical Corrections Act, (2) one change (item 3) is uncertain in meaning and may be read to produce one, two or three undesirable results which complicate the operation of the GST tax, (3) one change (item 4) has technical problems that need to be corrected, and (4) one change (item 2a) is unnecessary and is based upon an incorrect interpretation of current law.

1. Direct Skips and Taxable Terminations

IRC Sec. 2612(a) would be amended to add a new paragraph (3) stating that the term "taxable termination" shall not include a "direct skip." This paragraph should be modified to add after the words "direct skip" "determined without regard to [the $2 million grandchild exemption] and section 2612(c)(2)."

2. Charitable Transfers

a. Deduction

A new section (IRC Sec. 2625) would be added allowing a charitable deduction. The purpose of the section is explained in the Description of the Technical Corrections Act of 1987 prepared by the Joint Committee on Taxation as follows (page 262):

> For example, where property is placed in a trust which is to pay an annuity to the transferor's child for life, then an annuity to the transferor's grandchild for life with the remainder to go to charity at the grandchild's death, the amount subject to the generation-skipping transfer tax at the child's death is reduced by the value of the charitable remainder interest determined as of the child's death.

A charitable deduction is not needed in this case because no GST tax is imposed at the child's death. IRC Sec. 2652(c)(1) provides that charity is deemed to have an interest in a charitable remainder trust and, therefore, a taxable termination cannot occur with such a trust.

IRC Sec. 2625 is unnecessary and confusing and should not be added to Chapter 13.

b. Inclusion Ratio

A "related" change would amend IRC Sec. 2642(a)(2)(B)(ii) to remove the reference to any charitable deduction allowed by IRC Sec. 2055 or 2522 in computing the "applicable fraction" and the "inclusion ratio" of a trust. The fact that this change is substantive and not clarifying is made clear by applying it only to transfers made after June 10, 1987.

The determination to permit the value of a charitable transfer to be subtracted in computing the inclusion ratio of a trust was deliberate and had its genesis in the Treasury simplification proposal (H.R. 6260). The ABA participated with the Treasury in the development of its proposal, which involved compromises of conflicting views. Permitting the charitable deduction to be subtracted in computing the inclusion ratio was "offset" by making the termination of the interest of charity in a charitable lead trust a taxable termination rather than a direct skip to the extent trust property passed to grandchildren of the transferor. If the computation of the inclusion ratio is changed, the taxable termination result should also be changed. Nevertheless, the ABA submits neither change should be made and current law should be continued.

3. Separate Share Rule

A sentence would be added to IRC Sec. 2654(b) to state:

> Except as provided in the preceding sentence, nothing in this chapter shall be construed as authorizing a single trust to be treated as 2 or more trusts.

The Joint Committee Description is not helpful in determining what is intended by the sentence. Read literally, it does nothing because no provision in Chapter 13 authorizes a single trust to be treated as 2 or more trusts, except the first sentence of IRC Sec. 2654(b). However, an "undisclosed" meaning could be given to the proposed new sentence in one or more of three areas with undesirable results.

If the sentence is intended to prevent a trustee from dividing a trust that has an inclusion ratio of neither 1 nor zero into two trusts, one with an inclusion ratio of 1 and the other with an inclusion ratio of zero, we believe the change should not be made because it puts an emphasis on draftsmanship that is undesirable and will increase the expenses of administering trusts. Clearly, the draftsperson can accomplish the desired objective by providing that to the extent property added to a trust would cause the trust to have an inclusion ratio of more than zero such property shall not be added but rather shall be held as a separate trust upon the same terms as the "other" trust. Also, the one trust or two trust issue was addressed in the proposed regulations under IRC Sec. 2056(b)(7), which permit the division of a single marital deduction-credit shelter trust portion into two trusts, one not qualifying for the deduction and the other consisting of the marital deduction portion. See prop. Reg. §20.2056(b)-7(e), Example (11). The policy considerations are the same for each case and therefore the result should be the same - a division of a single trust into two trusts should be "permitted."

The change in the separate share rule might also be interpreted to prevent the use of a single QTIP trust and an allocation of the creator's GST exemption to a part of the trust. To illustrate, suppose T has an estate of $2 million and creates a credit shelter trust of $600,000 and a QTIP trust of the balance of his estate. The executor desires to make an election under IRC Sec. 2652(a)(3) as to $400,000 (4/14ths) of the trust. The surviving spouse's executor would then allocate her GST exemption to the balance of the trust property after her death. Arguably, the proposed new sentence is intended not to permit partial elections as to a QTIP trust. We disagree with such a result and do not understand why the creation of two trusts should be required in order to permit GST exemptions to be allocated thereto by each spouse.

The sentence could also justify a wrong result in allocating the GST exemption. Assume T creates a marital deduction QTIP trust which provides that upon the death of T's spouse the trust property is to be divided into two equal shares. The first share continues in trust for T's son. The second share continues in trust for T's descendants, and a Chapter 13 transfer as to this share would occur at the death of T's spouse. T's executor desires to make an election pursuant to IRC Sec. 2652(a)(3) and then to allocate T's GST exemption only to the second share. This result could be accomplished by creating two equal QTIP trusts. It should also be permitted with a single QTIP trust.

The ABA recommends no change be made in section 2654(b).

4. Use of GST Exemption for Certain Inter Vivos Transfers

A new subsection (e) would be added to IRC Sec. 2642. This subsection contains special rules concerning the inclusion ratio for a trust, and the allocation of the

GST exemption to the trust, where an _inter vivos_ transfer is made and the property transferred would be includible in the gross estate of the individual making the transfer (other than by reason of IRC Sec. 2035) if he died immediately after making the transfer. Paragraph (3) directs that if there is a distribution to a skip person before the death of such individual "such distribution shall be treated as a direct skip." This result seems inappropriate in some cases. To illustrate, assume that T creates a trust for his grandchild who is to receive the income for 2 years after which the trust property is to return to T. The first issue is whether subection (e) would apply. An _inter vivos_ transfer is made, but immediately after the transfer only a part but not all of the property transferred would be included in T's estate. Does this mean the subsection does not apply or that it applies only to the actuarial value of T's retained interest? The second issue is whether a distribution to the grandchild is a "distribution to a skip person." The transfer is a direct skip in an amount equal to the value of a 2 year income interest. Does this cause the transferor to change for purposes of determining whether there is a "distribution to a skip person"?

Suppose T creates an IRC Sec. 2503(c) trust for his grandchild and acts as trustee of the trust. The transfer to the trust is a completed gift for gift tax purposes in an amount equal to the full value of the trust property _and_ a direct skip. T should be able to allocate his GST exemption to the trust property. However, this could not be done because the trust property would be included in his gross estate under IRC Sec. 2038 if he died immediately after the transfer.

Subsection (e)(3)(B) states that if a distribution from the trust is a direct skip the transferor "may allocate a portion of his GST exemption to such distribution." This is inconsistent with the deemed allocation during life rule of IRC Sec. 2632(b), which provides that an allocation of the exemption shall be made to lifetime transfers unless the transferor elects out of this rule.

5. Effective Date Rules

a. "Gallo" $2 Million Exemption

Current law creates this exemption for transfers "to" a grandchild of the transferor that are made before January 1, 1990. The exemption would be modified by substituting a new section 1433(b)(3) which restricts its availability for a transfer in trust to a case where the income of the trust must be distributed at least annually to the grandchild after he or she attains age 21. This additional requirement is inconsistent with the instructions for the gift tax return (Form 709 (Rev. January 1987)) which require only that the trust property be vested in the grandchild for estate tax purposes. We know of cases where trusts for a grandchild were created in reliance on these instructions. It is unfair to disallow the exemption in such cases.

Furthermore, we believe mandating a current distribution of income is wrong. The reason for creating the trust may be to provide flexibility that can be achieved only through a trust and granting the trustee discretionary powers regarding the distribution of income or principal. This would be particularly important where the grandchild has a mental or physical illness.

If the income distribution requirement is retained the legislative history should state that in determining whether this requirement is met shall be determined in accordance with the regulations under IRC Sec. 2056(b)(5).

b. Mental Disability

The date for determining whether the decedent was under a mental disability would be changed from the date of enactment, October 22, 1986, to September 25, 1985. This means that if a decedent's mental disability commenced between these two dates property included in his gross estate would be subject to Chapter 13. We believe this result is bad policy. Such a person should be treated no less favorably than an individual who died before October 23, 1986 since mental disability is the same as death in terms of changing the disposition of property.

6. Omissions

a. Previously Taxed Property Credit

Chapter 13 is deficient in failing to provide relief similar to IRC Sec. 2013 when (1) a taxable termination occurs within 10 years of the creation of a trust with property included in a decedent's gross estate, (2) a taxable termination occurs within 10 years of a prior taxable termination regarding the same trust property or (3) a beneficiary receiving property after a taxable termination dies within 10 years of such termination. IRC Sec. 2611(b)(3) may have been intended to provide relief but it is of very limited scope and is not consistent with the approach of IRC Sec. 2013.

The need for relief may be illustrated by a simple case. T creates a trust of property included in his gross estate for his child C who dies 2 years after T's death and the trust property passes to C's surviving issue. Under current law, the trust property is subject to a Chapter 13 tax and the actuarial value of C's interests are eligible for the IRC Sec. 2013 credit in C's estate. Instead, the credit should be allowed to the trust and not to C in computing his estate tax. Also, the nature of C's interests in the trust should be immaterial in determining the amount of the credit.

b. Other Items

The ABA submitted a memorandum dated December 22, 1986 to staff regarding changes needed in Chapter 13. Changes suggested in items 4 (relating to the relationship between IRC Secs. 2611(b)(1) and 2652(a)(1)) and item 6 (relating to IRC Sec. 2612(a)(2)) are not dealt with in the Act. The ABA believes these matters should be addressed. Copies of these items are attached to this statement.

Statement of the
American Bankers Association
Submitted to the
Committee on Finance
United States Senate
July 16, 1987

The American Bankers Association (ABA) is pleased to submit comments on S. 1350, The Technical Corrections Act of 1987. The ABA is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA member banks are about 95 percent of the industry total.

Non-resident Alien Deposits

The ABA fully supports the language of Section 112(f)(4) of the bill which clarifies that the Tax Reform Act of 1986 (TRA'86) provision on the source of income rules for certain interest on deposits was not intended to change the treatment of those deposits for estate tax purposes. The tax code has long excluded from tax interest on deposits held for non-resident aliens. The TRA'86 simply changed the nature of this exclusion from a source rule exclusion to the specific exemption from the U.S. withholding tax. However, once the source rule was changed, bank deposits held by NRAs were inadvertently treated as U.S. property for purposes of the U.S. estate tax.

The clarification effectively incorporates the withholding tax exemption into the estate tax provision and applies as of the date that the withholding tax exemption was enacted. Thus, no federal estate tax would be applied against the deposits in a U.S. bank held by a non-resident alien even if the non-resident alien died after the date of the TRA'86 but before the date of enactment of the Technical Corrections bill.

In addition, the ABA urges the Committee to clarify that the change in the form of the exemption for interest paid to non-resident alien depositors was not intended to result in any additional information reporting with respect to those accounts. Both the Form 1099 reporting requirements under Section 6049 and the Form 1042S reporting requirement under the Section 1461 regulations already contain authority to exempt from reporting payments of interest to foreign depositors. There is no record of abuse that would justify imposing new reporting regulations on these accounts at this time. Moreover, U.S. banks should not be required to report about non-resident alien depositors who rely on the confidentiality of their banking relationship in the U.S. If that confidentiality were breached because of an IRS reporting requirement, those depositors might be in jeopardy of legal or extra-legal sanctions in their home country. It should be clear that the imposition of information reporting on non-resident alien depositors would likely force those depositors to withdraw their funds from U.S. banks and thereby undercut the purpose of the Section 871 and Section 881 exemptions from tax for deposit interest.

Accrual of Income on Short-term Obligations

The ABA believes that the change included in Section 118(d) of the bill needs to be expanded to include provisions similar to those contained in S. 1239.

The TRA'86 expanded the scope of Internal Revenue Code (IRC) Section 1281 to require all banks, regardless of their method of accounting, to accrue income on short-term obligations acquired after September 27, 1985. The Technical Corrections bill changes the effective date to obligations acquired after December 31, 1985. This change should eliminate the need for banks on the cash method, mostly smaller institutions located in the Midwest and West, to file amended returns for 1985. Many banks, however, have already filed their returns for 1986, not realizing this provision was included in the TRA'86.

Section 1281 was enacted as part of the Deficit Reduction Act of 1984 (DRA'84) and required banks to include in income currently the acquisition discount on short-term obligations. The Committee reports accompanying the DRA '84 indicate clearly that the rationale for the change was to discourage the leveraged acquisition of Treasury bills and other discounted obligations. There was no indication at that time that the provision was intended to cover short-term loans made by banks. The change to Section 1281 included in the Technical Correction section of the TRA '86, which expanded its application to loans made in the ordinary course of a trade or business, went largely unnoticed.

In addition, the broad question of whether a corporation can use the cash method of accounting was fully debated during consideration of the TRA'86. As a result corporations will be required to use the accrual method of accounting for tax purposes after December 31, 1986, with an exception for small businesses with gross receipts of $5 million or less. Moreover, the Senate provision limiting cash accounting, which would have applied to all banks, was dropped in conference in favor of the $5 million rule. Therefore, application of Section 1281 to loans made in the ordinary course of a trade or business undermines both the policy decision and the effective date decision made with respect to the general provision on cash accounting.

The ABA recommends that the revision of Section 1281 be made effective for obligations acquired after December 31, 1986, coincident with the change for cash accounting and that there be an exception to the application of Section 1281 to short-term loans made in the ordinary course of a trade or business by small banks on the cash method of accounting similar to the provisions contained in S. 1239.

Carryover of Pre-1987 Foreign Tax Credits by Financial Institutions.

The ABA recommends that the Technical Corrections Act address an inequitable and possibly unintended consequence in the IRC Section 904 transition rules enacted last year concerning the carryover of foreign withholding taxes incurred in pre-1987 years. The ABA recommends that foreign taxes paid prior to 1987 by banks and other taxpayers predominantly engaged in the banking business should be carried forward to the financial services income basket. This rule should apply both to income taxes on financial services income and withholding taxes on cross-border loan income to the 33 countries listed in the transition rule.

The general intent of the conferees was to permit taxpayers to carryforward pre-1987 unused credits without penalty. Indeed the conferees specifically adopted a Senate provision for taxpayers predominantly engaged in the active conduct of banking, financing, or similar business under which "pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on financial services income" (Conference Report II-585). The Secretary was given specific authority under Section 904 (d)(2)(I)(ii)(II) to provide that for taxpayers engaged in the active conduct of banking, financing or similar business all taxes paid or accrued with respect to income subject to the pre-1987 overall limitation would be treated for carryforward purposes as paid or accrued with respect to financial services income.

Any proposals to have pre-1987 credits put in the overall basket or the high withholding basket would give the TRA'86 a serious retroactive effect. At the time these loans were made, all banking income was in a single basket for foreign tax credit purposes. The conferees' action to grandfather certain existing loans from the high withholding tax basket argues against any retroactive treatment. All banks and other similarly situated taxpayers should be able to carryforward these credits to the financial services basket because any other rule will undermine the grandfather rule. It would create the rather illogical situation of permitting foreign taxes on certain cross-border loans to be included in the financial services basket during the 1987-1989 period and partially during the 1990-1994 phase out period, but that foreign taxes from the same loans earned in prior years would be subject to the new high withholding tax regime immediately.

Net Operating Losses

Section 903(a) of the TRA '86 amended Internal Revenue Code Section 172 to provide that commercial banks will be subject to the same net operating loss carryback and carryover rules as other corporation i.e. 3 years back and 15 years forward. Section 903(b) of the TRA '86 also amended IRC Section 172 to provide an exception to this general rule. If a commercial bank incurs a net operating loss for a taxable year beginning before January 1, 1994 which is attributable to a bad debt deduction allowed under the specific charge-off method, the loss shall be carried back 10 years and carried forward 5 years.

The ABA recommends that the statute allow the bank the option of using either the general corporate rules for the entire net operating loss or the bad debt exception.

The bad debt exception is a relief provision which was included in the TRA '86 to alleviate to a certain extent the repeal of the bad debt reserve method and its negative impact on the deferred tax accounts that commercial banks are required to maintain for financial and regulatory accounting purposes. It also appears that the exception was intended to provide relief for those banks which are incurring economic losses attributable to loan problems which could benefit from the retention of the 10 year carryback provision.

Many institutions which are having loan problems have already incurred large economic losses and have used up the ability to carry net operating losses back. These institutions, which are truly in need of a relief provision, should not be forced to use the bad debt exception when they would benefit most from being allowed to use the general rule providing a longer carryforward period in which to use these losses. If the bad debt exception was intended in part to provide relief for these institutions with bad debt problems then the purpose would be better served by allowing flexibility in the use of the provision.

Alternative Minimum Tax

The ABA recommends that the Committee consider a revision to address a possibly unintended gap in the effectiveness of the alternative minimum tax credit. Section 701 of the TRA '86 amended Internal Revenue Code Section 55 to impose an alternative minimum tax on corporations as well as other non-corporate taxpayers. New IRC Section 53 was also enacted to allow a credit for a prior year minimum tax liability. When a taxpayer pays alternative minimum tax, this tax generally is allowed as a credit against the regular tax liability of the taxpayer in a subsequent year. The minimum tax credit is allowed only with respect to the net minimum tax liability arising as a result of deferral adjustments and preferences and cannot be used to reduce minimum tax liability in subsequent years.

It appears that the minimum tax credit was enacted to ensure that the same amount of income would not be taxed under both the regular tax system and the alternative minimum tax system. In fact the credit appears to work well when a corporation claims a deduction on its tax return in one year and an expense on its financial statements in a subsequent year. It does not work as well when an expense is shown on the financial statement in one year but is not deductible for tax purposes until a subsequent year.

Attached are two examples which show the inequity of the situation. In Example 1 the corporation has a $200 expense for book purposes in 1987 which cannot be deducted for tax purposes until 1988. In Example 2 a corporation has a $200 deduction for tax purposes in 1987 which is not expensed for book purposes until 1988. At the end of 1988 in both examples, the two year cumulative book income amount is $50 and the two year cumulative taxable income amount is $50. In Example 1 the corporation has paid $27 in tax on $50 of (book and tax) income while in Example 2 the corporation has paid $17 of tax on the same amount of income. In these simplified examples, if there are no differences between book and taxable income in 1989, the discrepancy is resolved.

Congress has recognized in recent tax legislation that the time value of money is important. Therefore, it does not seem fair to have two corporations with the same amount of total income paying different amounts of tax. It appears that one possible solution to this situation would be to provide a carryback mechanism for the AMT credit. The carryback could be limited to allow a refund only to the extent that the AMT is attributable to deferral items.

Premium Amortization

Section 643 of TRA '86 amended IRC Section 171 to state that except as otherwise provided in regulations the deduction for amortizable bond premium is treated as interest expense. The ABA recommends that an exception be included in the statute that the amortizable bond premium not be considered interest expense for purposes of IRC Section 291(e)(1)(B)(iii) and Section 265(b)(4)(A).

Premiums paid on bonds represent an adjustment to the coupon rate on the bond. When this premium is paid on a taxable obligation it is a direct expense of acquiring the obligation and should be reflected as an offset to the income generated by such obligation. If the premium amortization is called interest expense for a financial institution, it may be considered part of the total interst expense subject to disallowance for purchasing or carrying tax exempt obligations. As noted above, premium amortization on a taxable obligation is a direct expense of acquiring a taxable obligation. It appears from the Conference Report and from discussions with the Joint Committee staff that the provision was included in the TRA'86 in order to make the deduction subject to the investment interest limitation for individuals and was not intended to cover financial institutions.

Although the statute does allow regulatory flexibility with respect to exceptions to this rule, a regulation project on this issue does not appear to be a priority for the Internal Revenue Service anytime in the near future. Therefore, the ABA recommends that the statute be amended to provide that premium amortization on taxable bonds not be considered interest expense for purposes of determining interest expense attributable to the purchase of tax exempt obligations.

* * * * *

Our Association appreciates the opportunity to comment on the Technical Corrections legislation. Additional information may be obtained from Henry Ruempler, Tax Counsel, American Bankers Association, 1120 Connecticut Avenue, N.W., Washington, D.C., 20036, (202) 663-5317.

American Bankers Association
Statement on S. 1350, Technical Corrections Act of 1987

Attachment

Summary - Example 1

	Book Income (Loss)	Current Tax Liability
1987	(100)	34
1988	150	(7)
1989	200	58
Total	250	85

Example 1

Assumptions:
1) 1987 is the corporation's first year operations
2) Loan Loss provision is the only difference between book income and regular taxable income.
3) Loan loss provision expensed for books in 1987, is deducted on the tax return in 1988.
4) Maximum corporate income tax rate is 34% for all years.

1987

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	100	100	
Loan Loss Prov.	(200)	-	
Tax Income	(100)	100	100
Tax		34	20

1988

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	150	150	
Loan Loss Prov.	-	(200)	
Tax Income	150	(50)	(50)
Book Income Adj.			100
Amt Income			50
Tax			10
NOL Carryback-Refund		(17)	

1989

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	200	200	
Loan Loss Prov.	-	-	
Tax Income	200	200	200
Book Income Adj.			-
AMT Income			200
Tax Before Credit		68	40
AMT Credit		(10)	
Tax		58	

Summary - Example 2

	Book Income (Loss)	Current Tax Liability
1987	100	-0-
1988	(50)	17
1989	200	68
Total	250	85

Example 2

Assumptions:
1) 1987 is the corporation's first year of operation.
2) Loan Loss Provision is the only difference between book income and regular taxable income.
3) Loan Loss Provision deducted on 1987 return is expensed on the books in 1988.
4) Maximum Corporate income tax rate is 34% for all years.

1987

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	100	100	
Loan Loss Provision	-	(200)	
Tax Income	100	(100)	(100)
Book Income Adj.			100
AMT Income			-0-
Tax		-0- (NOL Cfwd)	-0-

1988

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	150	150	
Loan Loss Provision	(200)	-	
NOL Carryforward	-	(100)	
Tax Income	(50)	50	50
Tax		17	10

1989

	BOOK	REGULAR TAX	AMT
Net Income Before Tax and Loan Loss Prov.	200	200	
Loan Loss Prov.	-0-	-0-	
Tax Income	200	200	200
Tax		68	40

STATEMENT ON S. 1350,

THE TECHNICAL CORRECTIONS ACT OF 1987

BY THE

AMERICAN COUNCIL ON EDUCATION

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON BEHALF OF:

American Association of Community and Junior Colleges
American Association of State Colleges and Universities
Association of American Universities
Association of Catholic Colleges and Universities
Association of Jesuit Colleges and Universities
Association of Urban Universities
Council of Independent Colleges
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Schools and Colleges of the United Methodist Church
National Association of State Universities and Land-Grant Colleges

On behalf of the American Council on Education, representing over 1,500 colleges and universities, and the associations listed on the cover sheet we wish to submit our comments on S 1350, the Technical Corrections Act of 1987, as it relates to Section 457 of the Internal Revenue Code.

Section 1107 of the Tax Reform Act of 1986 extended Internal Revenue Code Section 457, which previously only applied to state and local governments, to certain deferred compensation plans of tax-exempt employers.

Although the 1986 Act expanded the group of employers subject to Section 457, there was no indication by Congress that the substantive scope of Section 457 had been changed. Nevertheless, the Internal Revenue Service has taken an initial public position that the types and nature of deferred compensation plans governed by Section 457 include nonelective deferred benefit plans (*e.g.*, vacation pay plans, severance pay plans and nonelective retirement pay plans) which heretofore generally had been thought to be outside the scope of the Section 457 rules.

A clear statement through the Technical Corrections Act of 1987 (S 1350) is required to negate the overbroad interpretation by the IRS and to reaffirm that Section 457 *does not* extend to nonelective deferred compensation of tax-exempt organizations and state and local government employers.

AMERICAN BAR ASSOCIATION

Section of Real Property, Probate and Trust Law
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July 21, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
United States Senate
205 Dirksen Senate Office Building
Washington, DC 20510

Ms. Mary McAuliffe
Minority Chief of Staff
Committee on Finance
United States Senate
608 Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox and Ms. McAuliffe:

Enclosed, for each of you, are five (5) copies of an individual submission of comments with regard to the generation-skipping transfer tax provisions of the proposed Technical Corrections Act of 1987.

As the covering memorandum indicates, although this submission was developed by the appropriate committee of the Real Property Probate and Trust Law Section of the American Bar Association, it has undergone no formal review and evaluation process and should be taken as a submission by the named individuals only.

Very truly yours,

P H Schneider

Pam H. Schneider

SUBMISSION TO THE STAFFS OF THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES AND THE COMMITTEE ON FINANCE OF THE U.S. SENATE WITH RESPECT TO THE PROVISIONS OF THE TECHNICAL CORRECTIONS ACT OF 1987 (H.R. 2636 AND S 1360) CONCERNING THE GENERATION-SKIPPING TRANSFER TAX

Attached are two sets of comments relating to the generation-skipping transfer tax portions of the proposed Technical Corrections Act of 1987. The first set of comments deals with provisions in the Act; the second set deals with additional areas that we believe need to be addressed.

This material is being submitted by the undersigned in their personal and individual capacities. Although each holds officer and/or committee positions in the Real Property Probate and Trust Law Section of the American Bar Association, the materials have not received the approval of the Council of the Real Property Probate and Trust Law Section, nor, of course, of the American Bar Association itself. Therefore, the submission should not be taken as a submission of the American Bar Association or the Real Property Probate and Trust Law Section, but rather the submission of the individuals listed below.

This submission also incorporates the views of various individual members of the Section of Taxation of the American Bar Association. Ronald D. Aucutt, Chair of the Committee on Estate and Gift Taxation of the Section of Taxation advises us that for that reason, those views will not be separately submitted by those members of the Section of Taxation.

We hope you find the attached submission to be of use.

Respectfully submitted,

Joseph Kartiganer
L. Henry Gissel, Jr.
John J. Lombard, Jr.
Pam H. Schneider
Lloyd Leva Plaine
Mildred Kalik
Dave Cornfeld
Genevieve Lam Fraiman
Randall J. Gingiss
Carlyn McCaffrey
Jerry J. McCoy
Jeffrey N. Pennell
Regina O. Thomas
W. Steven Woodward

Comments Concerning Provisions of the Technical Corrections Act of 1987, S. 1350 and H.R. 2636, and the Joint Committee On Taxation's Description of the Technical Corrections Act of 1987 that Relate to the Generation-Skipping Transfer Tax

1. Taxable Termination Does Not Include Direct Skip.

Section 114(f)(3) of the proposed Technical Corrections Act of 1987 ("TCA-1987") would introduce new section 2612(a)(3) which provides that "the term 'taxable termination' shall not include any transfer which is a direct skip." The provision should be modified so that it is clear that a transfer will not be a taxable termination even if it would not be treated as a direct skip because of the application of the predeceased child exclusion of section 2612(c) or the $2 million per grandchild exclusion of section 1433(b)(3) of the Reform Act. One possible modification would involve deleting the period after the words "direct skip" and adding the following: "or which would have been a direct skip but for the application of section 2612(c)(2) or section 1433(b)(3) of the Tax Reform Act of 1986."

2. Deduction for Transfers for Public, Charitable and Religious Uses.

Section 114(f)(4)(A) of TCA-1987 would add new section 2625 which is designed to provide a generation-skipping transfer tax charitable deduction. Although a charitable deduction does not appear to have any significance in the situation described in The Joint Committee on Taxation's Description of the Technical Corrections Act of 1987 ("Description") it appears to be significant in other contexts.

The example in the Description appears to be incorrect because it ignores the fact that the charity, a non-skip person, would have an interest immediately after the death of the child, so there would not be a taxable termination. This is because a charity is considered to be in the generation of the transferor under the provisions of 2651(e)(3), and a charitable remainderman is considered to have an interest in a charitable remainder trust under section 2652(c)(1).

There are other situations, however, where a charitable deduction is permitted for estate and gift tax purposes but the charity would not be deemed to have an interest for generation-skipping transfer tax purposes. In such circumstances, a generation-skipping transfer tax charitable deduction might be both significant and desirable even if the change that would be made by Section 114(f)(4)(C) of TCA-1987 (discussed as item 3 below) is not made. For example, a transferor could give a life estate in his farm to his grandchild with the remainder passing to charity. The charity would not be deemed to have an interest in the farm and thus, without this deduction, a direct skip tax would have to be paid on the full value of the transfer even though a gift or estate tax charitable deduction would be permitted for the remainder interest.

This generation-skipping transfer tax charitable deduction would also be significant if section 2652(c)(1)(B) is construed to mean that where a particular charity is not specified, no "charity" has an interest in the trust (as for example where the trustee is directed to choose any section 170(c) organization). Consider a trust providing as follows: annuity to child for life then annuity to unspecified charity for 5 years then remainder to grandchild. On son's death, no person would have an interest in the trust so a taxable termination would occur and a charitable deduction would be significant. It is not clear, however, that this is what was intended by the new provision.

3. Use of Charitable Deduction in Computing the Applicable Fraction.

Section 114(f)(4)(C) of TCA-1987 would delete the provision that permits a charitable deduction (if allowed under section 2055 or 2522) in determining the denominator of the applicable fraction. This proposed change goes beyond the scope of technical corrections in that it does considerably more than "correct, clarify or conform" the various provisions of the Tax Reform Act of 1986. It is also inconsistent with the legislative intent. It creates a substantial disincentive to the use of charitable remainder trusts and charitable lead trusts that benefit grandchildren. The definition of the applicable fraction should continue to permit the denominator of the fraction to be reduced by the amount of any charitable deduction.

In the case of a charitable remainder trust, the change would mean that in order to exempt annual transfers to grandchildren from the generation-skipping transfer tax, GST exemption in the full amount of the trust principal must be used. For example, if a donor gives $100,000 to a charitable remainder trust to pay $10,000 a year for five years to his grandchild and then pay the principal to X charity, then, assuming the donor had already used his annual exclusion with respect to the grandchild, the donor would have to allocate $100,000 of GST exemption to avoid subjecting the five $10,000 annual payments to the generation-skipping transfer tax.

In the case of a charitable lead trust, the change would mean that a donor would be better off creating an accumulation trust to which GST exemption is allocated for a grandchild in an amount equal to the present value of the remainder interest than creating a charitable lead trust. Although it is true that permitting the charitable deduction to be deducted from the denominator of the applicable fraction would to some extent give an unintended benefit to a donor of a charitable lead annuity trust if the investment performance of the trust is better than that assumed by the I.R.S. tables, it is also true that not permitting such a deduction "penalizes" the donor of a charitable lead unitrust or the donor of a charitable lead annuity trust that does not outperform the tables. For example, under the Technical Corrections Act, if a donor creates a $300,000 charitable lead trust that is to pay $30,000 to charity each year for ten years, and then to pay the principal to the donor's grandchild, the donor would have to allocate $300,000 of GST exemption to the trust, so that, at the end of the tenth year (when the trust would, according to the tables, be worth $300,000) that full $300,000 would be exempt from the generation-skipping transfer tax, whereas if instead $115,662 had been put into a ten-year accumulation trust for the grandchild, then in 10 years, according to the 10% assumption of the I.R.S. tables, the grandchild would receive $300,000, and only $115,662 of GST exemption would have to have been allocated to the trust at creation to exempt the full $300,000 from the generation-skipping transfer tax.

A more thorough discussion of the reasons why present law should be retained will be included in a separate submission.

If the proposed change is made, then given the special nature of charities, if a charity has an interest and after the interest of the charity property passes to a skip person, a special rule should be added so that the transfer to the skip person is a direct skip, not a taxable termination or a taxable distribution. This rule would be similar to that provided in section 2642(e)(3) as proposed by TCA-1987. Without it the generation-skipping transfer tax that would be imposed at the termination of the charity's interest would be significantly greater than the tax that would have been imposed had the charity never had an interest.

If the provision in the Technical Corrections Act is retained, a transition rule should be added to give people who have charitable lead trusts in wills and revocable trusts time to change their documents.

4. <u>Special Rules for Certain Inter Vivos Transfers</u>.

Section 114(f)(5)(A) of TCA-1987 would add new section 2642(e). This section appears to have several technical problems:

(a) It is unclear how section 2642(e) works when property is transferred to a trust and immediately thereafter a portion (but not all) of the trust is potentially includible in the estate of the transferor. For example, if T transfers $100,000 to a trust and retains the right to receive an annuity of $6,000 a year, immediately after the transfer only $60,000 would be in it's gross estate. Does this mean the exemption could be allocated to the other $40,000? If so, how would this be done?

(b). Section 2642(e)(3) states that distributions made to skip persons before the transferor's death would be treated as a direct skip whether or not the transfer was subject to gift or estate tax. Further, it states that the transferor <u>may</u> allocate a portion of his GST exemption to it. It is not clear how this rule interacts with the automatic allocation provisions of section 2632(b). Wouldn't they apply to the transfer if it were a direct skip under this new provision?

(c) Perhaps most importantly, new section 2642(e) simply does not seem to work with respect to certain transfers outside the scope of section 2036. For example, if a transferor makes a taxable gift to a trust that is a skip person and over which the transferor retains section 2038 powers (which are not sufficient to prevent the transfer from being a taxable gift), generation-skipping transfer tax may be due prior to an effective allocation under section 2642(e) and prior to the valuation date prescribed by section 2642(e). This seems directly contrary to the deemed allocation rule of section 2632(e) and the policy behind it unless somehow a deemed allocation is treated as taking place outside of proposed 2642(e). A common example of a transfer that would have this problem is a transfer to a discretionary section 2503(c) trust for a grandchild with the transferor as the trustee. Another common example is a Uniform Gift to Minors Act transfer where the transferor is the custodian. If tax must be paid upon the transfer to the trust (because no allocation of exemption is effective) and property is subsequently distributed from the trust (or the Gift to Minors Act account), is the "skip person" determined in light of section 2653(a)? Will such a distribution be deemed a direct skip notwithstanding the treatment of the original transfer?

5. Support Obligations.

Section 114(f)(7) of TCA-1987 would add new section 2652(c)(3). It is unclear how this provision would apply to a trust that permits (but does not require) a trustee to use trust property for specific purposes such as a beneficiary's "health, support and education". The confusion arises from the words "if such use is not expressly provided for in the trust instrument". It would be more understandable if the provision stated that,

> "The fact that income or corpus of the trust may be used to satisfy an obligation of support arising under State law, shall be disregarded in determining whether a person has an interest in the trust unless the trust specifically provides that trust property shall be used to relieve another's obligation of support."

Unless the section is changed, it will be very difficult to draft a direct skip trust and still give guidance to the trustee as to how to use the property. The fact that a trust provides that a distribution may be made for a child's "support", "health", "education", etc., should not be treated as giving the parent an interest. Such a distribution will not necessarily "discharge" the obligation of support because the trust or the beneficiary may very well have a right of contribution against the parent.

6. Transferor.

Section 114(f)(10) of TCA-1987 would change the basic definition of the term "transferor" contained in section 2652(a)(1) by substituting the words "any property" for the words "a transfer of a kind" and by adding the following sentence: "An individual shall be treated as transferring any property with respect to which such individual is the transferor." This change is not fully explained in the Description. There appear to be two possible clarifications made by this change. It should be made clear if either or both were intended.

First, under this provision it appears that upon the lapse of a withdrawal power over a trust in an amount greater than $5,000 or 5% of the value of the trust, the power holder becomes the transferor to the extent of the excess and the original transferor remains the transferor with respect to the property up to the "five and five" amount. Thereafter, the trust would presumably be treated for generation-skipping transfer tax purposes as separate trusts with different transferors.

Second, the change in the definition of the term "transferor" seems to clarify that immediately upon property becoming subject to estate or gift tax with respect to an individual (and before it is determined whether or not a generation-skipping transfer has occurred), the individual becomes the new transferor and the old transferor drops out. This is consistent with the section 2652(a)(3) QTIP election. However, it appears that section 2611(b)(1) may be without significance.

The following example illustrates this last statement. Assume that a trust is created by A in which A's daughter, B, has a general testamentary power of appointment and on B's death the property passes to B's child (A's grandchild), C. Under the proposed new definition of "transferor," it seems clear that B is the transferor of the transfer to her child, C. As a result, section 2611(b)(1) is not needed to prevent the imposition of both a generation-skipping transfer tax and an estate tax on B's death (as C is a non-skip person with respect to B). If property instead passes to B's grandchild (A's great-grandchild), there would be a direct skip on B's death with or without section 2611(b)(1).

7. <u>Separate Share Treatment</u>.

Section 114(f)(14) of TCA-1987 would change section 2654(b) to add a sentence that states that: "Except as provided in the preceding sentence, nothing in this chapter shall be construed as authorizing a single trust to be treated as 2 or more trusts." It is not clear what was intended by this additional sentence.

This provision may effect trusts with multiple transferors (such as a trust created with jointly held or community property or a trust to which different individuals have made transfers) by restricting the Treasury from promulgating regulations to deal effectively with such trusts.

Multiple transferors can also result from a partial section 2652(a)(3) election. We assume this provision was not intended to prohibit such partial elections.

We also assume that this provision was not intended to imply that a transferor cannot by formula create two identical trusts, or that an executor or trustee, if permitted to do so by state law or the governing instrument, cannot divide a trust into two or more separate trusts. Allowing a taxpayer to divide a trust into more than one trust will not lead to abuse. Indeed, the purpose of the $1 million exemption was to take certain trusts out of the system for administrative reasons. Allowing trusts to be split into exempt and non-exempt trusts simply helps to facilitate the efficient administration of the generation-skipping transfer tax. Furthermore, as it is always possible to create a separate exempt trust during life or to create more than one trust in a testamentary document, forbidding the division of trusts would merely operate to the detriment of those who do not have sufficient assets to give away $1 million during life and result in a trap for those who do not realize that separate trusts are sometimes necessary to obtain the full benefit of the $1 million exemption or who do not anticipate that their assets will appreciate to over $1 million at the date of death. Thus, a prohibition on splitting trusts with different inclusion ratios would: (i) defeat the Congressional intent to give each taxpayer the ability to make a full $1,000,000 of generation-skipping transfers without generation-skipping transfer tax,

(ii) cause many trusts to be partially taxable and partially exempt, with the associated difficulties for those paying the tax as well as for those enforcing payment, and (iii) require draftsmen to create multiple trusts to qualify for the full $1,000,000 exemption, thus increasing technical difficulty to no substantive end.

It should also be made clear, perhaps by regulation, that a permissible division of a trust after the exemption is allocated can result in separate trusts with different inclusion ratios, if the trustee so designates, based on the fair market value of the trust at the time of the division.

If a new rule is adopted which would prevent such divisions, a transitional rule should be added to give people whose estate plans are premised on the ability to divide, time to change their documents.

A more detailed discussion of this provision will be sent as a separate submission.

8. Effective Date Provisions.

Section 114(g)(2)(D) of TCA-1987 would amend section 1433(c) of the Reform Act to change the determinative date of incompetency from the date of enactment (October 22, 1986) to September 25, 1985. This change is inappropriate for three reasons. First, it is not a technical change but, rather, a substantive one. Second, it is not consistent with the other effective date and transition rule provisions included in the Act. Third, it is a change from the comparable provision in the House Bill (section 1223(b)(2)(B) of H.R. 3838), which was reported by the House Ways and Means Committee on December 7, 1985.

The determinative date for mental incompetency should be the same determinative date as that used for the transition rule with respect to wills executed before a certain date. Such a transition rule is intended to give individuals with existing documents an opportunity, after the date of enactment, to change those existing documents in order to take into account the newly enacted provision. A person who is incompetent on the date of enactment and thereafter until death has no opportunity to change the existing documents in order to take into account the new tax. Accordingly, just like the person who dies before the grace period, the incompetent individual should not be subject to the tax. Thus, as section 1433(c)(2)(B) provides that a transfer under a will in existence on October 22, 1986 is not subject to the tax if the decedent dies before January 1, 1987, so should October 22, 1986 be the relevant date for incompetency even where the decedent dies after January 1, 1987, provided that decedent was not capable of changing the will or other testamentary documents after that date.

While it is true that section 1433(c)(2)(A) of the Reform Act subjects certain inter vivos transfers made after September 25, 1985, to the tax, this is not the analogous provision. Irrevocable inter vivos transfers are made with the knowledge that the governing documents cannot be changed. This is not the case with testamentary documents. Such documents are always written with the idea that they will be changed to reflect changes in the law unless the person dies prior to such a change. If such a document cannot be changed, not by reason of death, but by reason of incompetency, the appropriate transition rule to apply would be the same provisions that would apply if the person had died on the date on which the person became incompetent. Certainly one entering incompetency after September 25, 1985, but before October 22, 1986, should not have been more alert to pending legislation than one competent to execute his will during such period, but who happens to die prior to January 1, 1987. Furthermore had a future incompetent in 1985 been alert to legislation he or she would have been alert to legislation that included a "date of enactment" date for the transition rule relating to incompetency.

9. $2 Million per Grandchild Exclusion.

Section 114(g)(3) of TCA-1987 would add section 1433(b)(3) to the Reform Act. It provides that certain transfers to a trust for a grandchild will qualify for the grandchild exclusion. This provision gives rise to several concerns:

(a) The requirement that income be distributed currently to the grandchild beginning at age twenty-one seems unnecessarily restrictive, and often does not make sense from a dispositive perspective. Such a requirement can be detrimental in the case of a normal grandchild and certainly would be detrimental in the case of a grandchild who is incapacitated or disabled. If the marital deduction is deemed to be an appropriate analog, the marital deduction estate trust should be considered just as analogous as the QTIP. As long as any undistributed income is includible in the gross estate of the grandchild, it would be subject to estate tax at the death of the grandchild and the transfer tax effect would be no different.

Several questions arise by virtue of the requirement that income be paid currently. For example, must the transferred property be income producing consistent with the requirement for the marital deduction? A more detailed discussion of the problems with this provision will be included in a separate submission.

If the current income requirement is retained it should be given a later effective date and an appropriate transition rule as it is inconsistent with the instructions to the newly released Form 709. Some people may have created irrevocable trusts and drafted wills or revocable trusts in reliance on the instructions in the federal gift tax return.

(b) Some confusion is created by the clause "(or for the benefit of)" in section 1433(b)(3)(B)(i) of the Reform Act. It should be made clear that the mere possibility that a distribution might be made that would satisfy someone's obligation of support would not disqualify a trust for the $2 million per grandchild exclusion. Certainly such a possibility does not prevent a similar trust from qualifying for the marital deduction. If a surviving spouse remarries and the new spouse has a legal obligation to support the survivor, the fact that trust property may be used to pay items of support does not disturb the marital deduction.

(c) It is not clear whether the election under section 1433(d) of the Reform Act for transfers made before the date of enactment are subject to the new income requirements of section 1433(b)(3)(B). If the new income requirement is retained, the Technical Corrections Act should make it clear that this requirement does not apply to determine eligibility of a trust for an election under section 1433(d) of the Reform Act.

Additional Items for Technical Corrections Act of 1987 to the Generation-Skipping Transfer Tax

1. Credit for Property Previously Taxed. Chapter 13 does not contain any credit for property previously subject to a GST tax or an estate tax under circumstances in which such property would be entitled to a credit under §2013 if the property were subject to estate tax rather than GST tax. It appears that §2611(b)(3) may have been intended to provide such a credit but it does not accomplish this result. The absence of a "PPT" credit in Chapter 13 creates an incentive to avoid the GST tax by incurring an estate tax even where for other, non-tax reasons transferors do not want their beneficiaries to have the control over the property to the extent necessary to result in an estate tax. At least in the case of taxable terminations occurring on and as a result of the death of an individual this difference in treatment (between the estate tax and GST tax) creates serious inequities.

We recommend modifying §2611(b)(3) so that it operates as a PPT credit analogous to §2013. A more far reaching alternative (which we believe would be a substantial improvement to the tax) would be an election that would permit a trustee to avoid paying a GST tax on a taxable termination that occurs on and by reason of the death of an individual by agreeing to pay an estate tax on the trust property as if such property were included in the individual's estate.

2. Computation of Inclusion Ratio and Annual Exclusion Transfers. The computation of the inclusion ratio does not seem to work properly in the case of certain transfers that qualify for the annual exclusion. These problems do not appear to be fixed by §114(f)(12) of the Technical Corrections Act. However, these problems would appear to be solved if, instead of excluding annual exclusion transfers from the denominator of the applicable fraction as is provided in §2642(c), and instead of not requiring a recomputation of the inclusion ratio under §2642(d) on an annual exclusion addition, such transfers were included in both the numerator and the denominator of the applicable fraction for purposes of both §2642(a) and (d).

Consider the following example: Assume a trust to which $20,000 was transferred in 1988 of which $15,000 qualified for the annual exclusion. Assume further that in 1989 another $20,000 is transferred to the trust and again $15,000 qualifies for the annual exclusion. Also assume that immediately before the 1989 transfer the trust had a value of 20,000.

(a) If in 1988 no part of any GST Exemption was allocated to the trust (and the Applicable Fraction immediately before the second transfer was 0), and in 1989 5,000 of the GST Exemption is allocated to the new transfer, the recomputed Applicable Fraction is:

$$\frac{5{,}000 + (20{,}000 \times 0)}{5{,}000 - 0 + 20{,}000}$$

$$= \frac{5{,}000}{25{,}000} = \frac{1}{5} = 20\%$$

and the Inclusion Ratio is 80% (1-20%). Thus, tax due on the entire trust is reduced by only 20% even though with respect to transfers totalling $40,000, $35,000 qualified for either the annual exclusion or were covered by GST exemption.

(b) If in 1988 $5,000 of the GST exemption was allocated to the trust (so the applicable fraction immediately before the second transfer was 1), and in 1989 no portion of the exemption is allocated to the trust, then the recomputed Applicable Fraction is:

$$\frac{0 + (20{,}000 \times 1)}{5{,}000 - 0 + 20{,}000}$$

$$\frac{20{,}000}{25{,}000} = \frac{4}{5} = 80\%$$

and the Inclusion Ratio is 20% (1-80%) and the tax rate to which the trust is subject is reduced by 80%. Reversing the time of the GST allocation from example (a) has had a dramatic impact on the taxability of the trust even though nothing else has changed. This does not seem to be an appropriate result.

If the statute were modified as suggested then the results of the above examples would change as follows:

(i) In (a) above, the applicable fraction after the 1988 transfer would be computed as follows:

$$\frac{15{,}000}{20{,}000} = \frac{3}{4} = 75\%$$

and the Inclusion Ratio would be 25% (1-75%). After the 1989 transfer the recomputed Applicable Fraction would be

$$\frac{20{,}000+(20{,}000 \times 75\%)}{20{,}000+20{,}000}$$

$$= \frac{35{,}000}{40{,}000} = 87.5\%$$

and the Inclusion Ratio would be 12.5%

(ii) In (b) above, the Applicable Fraction after the 1988 transfer would be computed as follows:

$$\frac{20{,}000}{20{,}000} = 1$$

and the Inclusion Ratio would be 0. After the 1989 transfer the recomputed Applicable Fraction would be

$$\frac{15{,}000+(20{,}000 \times 1)}{40{,}000}$$

$$= \frac{35{,}000}{40{,}000} = 87.5\%$$

and the Inclusion Ratio would be 12.5% -- the same as (i). Certainly the more rational result is that, where values don't change, the timing of the allocation of the exemption does not affect the inclusion ratio.

3. Deemed Allocations to Lifetime Direct Skips. The general rule is that, unless the individual elects otherwise, the "unused portion" of an individual's $1 million GST exemption is deemed allocated to each lifetime direct skip of the individual in order of occurrence. §2632(b)(1). However, there appears to be a typographical error in the definition of the "unused portion". As written, it is defined as that portion that has not previously been allocated with respect to a prior direct skip. §2632(b)(2). Thus, it is arguable that a failure to elect out of this provision can undo a prior allocation to property in a trust that is not a Skip Person, because the transfer to the trust was not a direct skip. However, this problem evaporates if the close parenthesis in §2632(b)(2) is moved to the end of the sentence rather than after "(1)."

AMERICAN BAR ASSOCIATION
Section of Real Property, Probate and Trust Law
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August 31, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
United States Senate
205 Dirksen Senate Office Building
Washington, DC 20510

Ms. Mary McAuliffe
Minority Chief of Staff
Committee on Finance
United States Senate
608 Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox and Ms. McAuliffe:

On behalf of the individual members of the Real Property, Probate and Trust Law Section of the American Bar Association whose names are reflected below my name, we hereby indicate our agreement with the submission made by individual members of the Section of Taxation of the American Bar Association dealing with Proposed Technical Corrections to Sections 2035 and 2038 (relating to gifts within three years before death). A copy of that submission is attached. Although neither Section 2035 nor Section 2038 is otherwise addressed in the Technical Corrections Act, I believe you are already aware of the technical problems that are identified in the attached submission.

Consistent with the attached submission, this letter represents the individual views of the members of the Real Property, Probate and Trust Section whose names are listed below my name and does not purport to state the position of the American Bar Association or the Real Property, Probate and Trust Section of the American Bar Association. However, it should be noted that a substantially identical legislative recommendation (ABA Proposal 106A enclosed) was adopted by the House of Delegates of the American Bar Association at its August 1983 annual meeting.

Sincerely,

Frederick R. Keydel

Frederick R. Keydel
Liaison to Section of Taxation
Jonathan G. Blattmachr
James L. Boring
Dave L. Cornfeld
L. Henry Gissel, Jr.
Philip J. Hirsch
Joseph Kartiganer
Lloyd Leva Plaine
John A. Wallace

FRK:vm
0461R(11)(b)-02
Enclosures

AMERICAN BAR ASSOCIATION

SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

REPORT TO THE HOUSE OF DELEGATES

RECOMMENDATION

BE IT RESOLVED, That the American Bar Association supports enactment by Congress of amendments to Sections 2035 and 2038 of the Internal Revenue Code of 1954 along the lines set forth in Exhibit A, attached, to conform to the provisions of the Economic Recovery Tax Act of 1981 and the Technical Corrections Act of 1982.

REPORT

The Section of Real Property, Probate and Trust Law has joint jurisdiction with the Section on Taxation over matters relating to the United States estate tax. This recommendation was approved by the Council of the Section of Real Property, Probate and Trust Law, having authority to act for the Section, at its regularly-scheduled meeting on April 24, 1983, at Point Clear, Alabama. This recommendation was approved by the Estate and Gift Tax Committee of the Section on Taxation at its meeting in Washington, D.C. on May 20, 1983, and will be considered by the Council of the Section on Taxation as an expedited matter before the August, 1983 meeting of the House of Delegates of the American Bar Association.

In the Economic Recovery Tax Act of 1981 (ERTA) Congress amended I.R.C. §2035 by adding a new subsection (d). This new subsection eliminates most intervivos transfers from a decedent's gross estate. I.R.C. §2035 as amended by ERTA and the Technical Corrections Act of 1982 now provides:

1. The gross estate includes any gift taxes paid by a decedent or his estate on any taxable gifts made within 3 years prior to death.

2. Except for transfers for full consideration, the gross estate includes any interest in property transferred within 3 years prior to death if such interest would have been included in the decedent's gross estate under I.R.C. §§2036, 2037, 2038 or 2042 had it been retained by the decedent.

3. For purposes of I.R.C. §303(b) (distributions in redemption of stock to pay death taxes), §2032A (special valuation of certain farms, etc., real property), §6166(a) (extension of time to pay estate tax), and subchapter C of Chapter 64 (lien for estate tax), the old rules of I.R.C. §2035 apply, i.e., all transfers within 3 years of death are includible in the gross estate except those for full consideration and those small enough to come within the annual gift tax exclusion so that no gift tax return was required to be filed.

However, as presently drafted I.R.C. §2035(a) states the former general rule: the value of a decedent's gross estate includes the value of all property to the extent of any interest therein which the decedent transferred during the 3-year period ending on his death. Subsections (b) and (d) now set forth exceptions that render the former general rule meaningless, except for transfers under (b)(2) (with respect to a life insurance policy), (d)(2) (within the scope of I.R.C. §§2036, 2037, 2038 and 2042), and except for the special rules of I.R.C. §§303(b), 2032A, 6166, and subchapter C of Chapter 64 that are referred to in subsections (d)(3) and (4).

The proposed rewrite of I.R.C. §2035 is not intended to change existing law but to be a nonsubstantive rewrite making the section more comprehensible. However, the last sentence of proposed subsection (a) has been added to correct a potential but unintended trap in the present statutory language: All gifts from a revocable trust, made by or on behalf of its settlor, may technically be includable under I.R.C. §2035(d)(2) since any such transferred property would otherwise have been included in the settlor's gross estate under I.R.C. §§2036, 2037 or 2038, and not under I.R.C. §2033. However, such a transaction is analytically a distribution by the trustee to the settlor, followed by a gift by the settlor to the donee, and should be subject to the same rules as apply to the settlor's donations as an individual.

As a corollary, all gifts from a revocable trust within 3 years of the settlor's death would apparently also be caught by I.R.C. §2038(a)(1) and (2), as any such transfer could be construed as a relinquishment of a power to "alter, amend or revoke" during "the 3 year period ending on the date of the decedent's death". See Cremer, The 1981 Act and Section 2035: Problems and Possibilities. 35 The Tax Lawyer 389, 393-4 (1982). In order to cure this problem and to let Section 2035 set the operative rules, it is recommended that I.R.C. §2038 be amended by adding at the end of I.R.C. §2038(a)(1) and at the end of the first sentence of I.R.C. §2038 (a)(2) the following:

> "(except when such relinquishment results from a transfer from a trust as to which trust the settlor has reserved a right of revocation)."

Respectfully submitted,

Malcolm A. Moore, Chairman

EXHIBIT A

PROPOSED REVISION OF INTERNAL REVENUE CODE §2035

SEC. 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

(a) INCLUSION OF CERTAIN TRANSFERS IN GROSS ESTATE - The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death, if such transferred interest would have been included in the decedent's gross estate under Sections 2036, 2037, 2038 or 2042, had such transferred interest been retained by the decedent on the date of his death. The provisions of this subsection (a) shall not apply to any transfer from a trust as to which trust the settlor has reserved a right of revocation unless such transfer, if made directly by the settlor, would be a transfer to which this subsection (a) would apply.

(b) INCLUSION OF GIFT TAX ON GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH - The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.

(c) <u>INCLUSION OF TRANSFERS WITHIN THREE YEARS OF DEATH FOR CERTAIN PURPOSES</u>.

(1) For purposes of Section 303(b) (relating to distributions in redemption of stock to pay death taxes), Section 2032A (relating to special valuation of certain farms, etc., real property), and subchapter C of Chapter 64 (relating to lien for taxes), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(2) An estate shall be treated as meeting the 35-percent of adjusted gross estate requirement of Section 6166(a)(1) only if the estate meets the requirement both with and without including in the value of the gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(3) The provisions of (1) and (2) above of this subsection (c) shall not apply to any transfer (other than any transfer with respect to a life insurance policy) made during a calendar year if the decedent was not required by Section 6019 (other than by reason of Section 6019(a)(2) to file any gift tax return for such year with respect to such transfer.

(d) <u>DEFINITION</u> - For purposes of this section, the term "transfer" shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

<u>PROPOSED REVISION OF INTERNAL REVENUE CODE §2038</u>

SEC. 2038. REVOCABLE TRANSFERS.

(a) <u>IN GENERAL</u>. - The value of the gross estate shall include the value of all property--

(1) TRANSFERS AFTER JUNE 22, 1936. - To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death <u>(except when such relinquishment results from a transfer from a trust as to which trust the settlor has reserved a right of revocation)</u>.

(2) TRANSFERS ON OR BEFORE JUNE 22, 1936. - To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death <u>(except when such relinquishment results from a transfer from a trust as to which trust the settlor has reserved a right of revocation)</u>. Except in the case of

transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

PROPOSED TECHNICAL CORRECTIONS TO SECTION 2035
(RELATING TO GIFTS WITHIN THREE YEARS BEFORE DEATH)

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

This report was prepared by members of the Committee on Estate and Gift Taxes. Members who participated in preparation of the report are Beverly R. Budin, Michael W. Stukenberg, Shirley D. Peterson, and Ronald D. Aucutt.

A PROPOSAL TO REMOVE A TRAP INADVERTENTLY CREATED
BY THE WORDING OF SECTION 2035, AND TO SIMPLIFY
SECTION 2035 BY THE REMOVAL OF "DEADWOOD"

BACKGROUND

1. Statutory History

Prior to the Tax Reform Act of 1976, Section 2035 provided that, except in the case of a bona fide sale for an adequate and full consideration in money or money's worth, transfers made "in contemplation of death" would be included in the gross estate of the decedent. Transfers made within the three-year period ending on the decedent's were presumed to have been made in contemplation of death; while transfers made prior to the three-year period were conclusively determined not to have been made in contemplation of death.

The 1976 Act modified Section 2035 by adopting a rule which provided that all gifts made by a decedent within the three-year period prior to death are included in the decedent's gross estate, with an exception for gifts which did not require the filing of a gift tax return. Thus, gifts within the annual exclusion amount would not be included in the decedent's gross estate.

In 1981 Congress revised Section 2035 by eliminating the general rule that gifts made within the three-year period ending on the date of the decedent's death would be included in the decedent's gross estate. This change was a reflection of the 1976 unification of the federal gift and estate tax systems. In general, under the unified system, property which is gifted is taxed in the same manner as property which is included in the decedent's gross estate, except that property which is gifted is valued as of the date of the gift, rather than the date of death. Thus, the elimination of the general rule of Section 2035 simply allowed gifts which were made within the three-year period prior to the decedent's death to be valued in the transfer tax base as of the date of the gift (rather than as of the date of death).

While the general rule of Section 2035 has been eliminated, Section 2035(d)(2) retains the three-year rule with respect to "a transfer of an interest which is included in the gross estate under Sections 2036, 2037, 2038 or 2042 or would have been included under any of such sections if such interest had been retained by the decedent." Thus, for example, if a decedent who has transferred property and retained a life estate in the transferred property released his life estate within the three-year period prior to his death, the gross estate would include the value of the transferred property at the time of death. The apparent statutory intent of the Section 2035(d)(2) exception is to prevent decedents from making deathbed transfers or releases of reversionary interests, life estates, incidents of ownership in insurance policies, or other powers of revocation, control or ownership in gifted property which would have a small gift tax value compared to the estate tax value (if the decedent died possessing the power or interest).

2. <u>TAM 8609005</u>

In TAM 8609005 the decedent created a revocable trust. The trustees had the power to distribute up to $10,000 a year to each of the decedent's children. The trustees exercised this power at the decedent's request, making gifts equal to the annual exclusion amount in each of the three years prior to the decedent's death. The Service ruled that since the distributed property would have been included in the decedent's gross estate <u>under Section 2038</u> had the distributions not been made, the transfers were included in the decedent's gross estate under Section 2035(d)(2).

PROPOSALS FOR TECHNICAL CORRECTION

1. <u>Reversal of TAM 8609005</u>

The intent of Section 2035(d)(2) is to avoid the erosion of the transfer tax base by including in the gross estate property which was transferred within the three-year period prior to death where the gift tax value of the transfer is less than the estate tax value would have been had the transfer not been made. Typical examples are transfers of a retained life estate or transfers of policies of insurance on the life of the decedent. No purpose of the tax system is served by including in the gross estate transfers that are made from a trust which, had they been made directly by the decedent, would not have been included in the gross estate.

Section 2035(d)(2) presently is a trap for those unaware of what almost certainly is an unintended consequence of Section 2035(d)(2). Those aware of the consequence will structure their transfers in a manner which will avoid the undesired tax result, but this may involve unnecessary inconvenience.

While the situation set forth in TAM 8609005 (the revocable trust) is probably the most common situation which creates an inequitable result under Section 2035(d)(2), it is not the only one.

EXAMPLE: A creates an irrevocable trust for the benefit of her issue, retaining the right to determine what distributions are to be made. In 1988 A directs the trustee to make distributions of $10,000 to each of her two children and four grandchildren.

In the foregoing example, as in the situation in TAM 8609005, had the transfers been made directly by the decedent, they would not have been included in the decedent's gross estate. No tax policy is served by treating the transfers differently because they were made from a trust. Attached hereto, as Exhibit "A," is a draft of Section 2035(d)(2), revised to eliminate from its scope transfers which do not fall within the tax purposes of Section 2035. Attached hereto, as Exhibit "A-1," is a draft of Section 2038, revised in a manner corresponding to the revision of Section 2035(d)(2).

2. Simplification of Section 2035

As a result of the various amendments to Section 2035, the structuring of that section is needlessly complex. The general rule of Section 2035 is set forth in Section 2035(d)(1), while Section 2035(a) was effectively revoked by Congress in 1981. Because of this ordering, anyone unfamiliar with Section 2035 will have difficulty in understanding its intent. Attached hereto, as Exhibit "B," is a draft of Section 2035, revised to (a) rewrite the section to eliminate the "deadwood" and (b) make the same revision as made in Exhibit "A."

EXHIBIT "A"

PROPOSED REVISION OF INTERNAL REVENUE CODE SECTION 2035

SEC. 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN THREE YEARS OF DECEDENT'S DEATH.

(2) EXCEPTION FOR CERTAIN TRANSFERS. Paragraph (1) of this subsection and paragraph (2) of subsection (b) shall not apply to a transfer of an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038 or 2042 or would have been included under any of such sections if such interest had been retained by the decedent. The preceding sentence shall not apply to any transfer from a trust unless such transfer, if made first to the decedent (whether or not this is permissible under the trust instrument) and then by the decedent, would be a transfer to which the preceding sentence would apply.

EXHIBIT "A-1"

PROPOSED REVISION OF INTERNAL REVENUE CODE §2038

SEC. 2038. REVOCABLE TRANSFERS

(a) IN GENERAL - The value of the gross estate shall include the value of all property--

(1) TRANSFERS AFTER JUNE 22, 1936 - To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the three-year period ending on the date of the decedent's death (except when such relinquishment results from a transfer from a trust and the transfer would not require inclusion in the decedent's gross estate under Section 2035).

(2) TRANSFERS ON OR BEFORE JUNE 22, 1936 - To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the three-year period ending on the date of the decedent's death (except when such relinquishment results from a transfer from a trust and the transfer would not require inclusion in the decedent's gross estate under Section 2035). Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

EXHIBIT "B"

PROPOSED REVISION OF INTERNAL REVENUE CODE SECTION 2035

(a) INCLUSION OF CERTAIN TRANSFERS IN GROSS ESTATE _ The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer, by trust or otherwise, during the three-year period ending on the date of the decedent's death, if such transferred interest would have been included in the decedent's gross estate under section 2036, 2037, 2038 or 2042, had such transferred interest been retained by the decedent on the date of his death. The preceding sentence shall not apply to any transfer from a trust unless such transfer, if made first to the decedent (whether or not this is permissible under the trust instrument) and then by the decedent, would be a transfer to which the preceding sentence would apply.

(b) INCLUSION OF GIFT TAX ON GIFTS MADE DURING THREE YEARS BEFORE DECEDENT'S DEATH - The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under Chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the three-year period ending on the date of the decedent's death.

(c) INCLUSION OF TRANSFERS WITHIN THREE YEARS OF DEATH FOR CERTAIN PURPOSES.

(1) For purposes of Section 303(b) (relating to distributions in redemption of stock to pay death taxes), Section 2032A (relating to special valuation of certain farms, etc., real property), and subchapter C of Chapter 64 (relating to lien for taxes), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the three-year period ending on the date of the decedent's death.

(2) An estate shall be treated as meeting the thirty-five percent of adjusted gross estate requirement of Section 6166(a)(1) only if the estate meets the requirement both with and without including in the value of the gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the three-year period ending on the date of the decedent's death.

(3) The provisions of (1) and (2) above of this subsection (c) shall not apply to any transfer (other than any transfer with respect to a life insurance policy) made during a calendar year if the decedent was not required by Section 6019 (other than by reason of Section 6019(a)(2)) to file any gift tax return for such year with respect to such transfer.

(d) DEFINITION - For purposes of this section, the term "transfer" shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

AMERICAN BAR ASSOCIATION

Section of Real Property, Probate and Trust Law
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October 1, 1987

BY MESSENGER

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
1102 Longworth Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

I am enclosing an individual submission with regard to the provisions of the Technical Corrections Act of 1987 (to be redesignated Section 4980A) dealing with Section 4981A of the Internal Revenue Code. Although the submission was developed by individual members of the Real Property, Probate and Trust Law Section of the American Bar Association, it has not received the approval of the Council of the Real Property, Probate and Trust Law Section, nor, of course, of the American Bar Association itself. Therefore, the submission should not be taken as a submission of the American Bar Association or the Real Property, Probate and Trust Law Section, but rather the submission of the named individuals only.

Sincerely,

Lloyd Leva Plaine

Lloyd Leva Plaine

Comments on Section 4981A
(Redesignated as Section 4980A by the
Proposed Technical Corrections Act of 1987)

1. As a policy matter, Section 4981A may be criticized for imposing a heavier tax burden on the estates of employees who die before withdrawing their excess benefits than on those who withdraw the excess benefits before death. The death of an employee who dies before withdrawal

not only accelerates the tax, but also causes his or her estate to be taxed more heavily because the supplemental estate tax is not deductible in computing the employee's regular estate tax. Had the excise tax been imposed during the lifetime of the employee, the excise tax payment would be excludable from the employee's estate (or deductible if the tax is accrued but unpaid). While there is a similar result with respect to the income tax on plan distributions, in the case of the income tax, the tax is not due until distributions are made. That is, the tax is not accelerated at death. To prevent the employee's death from creating an increased tax burden, the supplemental estate tax imposed by Section 4981A should be either deductible in computing the regular estate tax or deferred until distributions are made.

The supplemental ~~estate tax~~ imposed by Section 4981A may be higher than the excise tax for which it substitutes because an employee who withdraws plan benefits during his or her lifetime may effectively double the exemption amount by (1) withdrawing a lump sum from one retirement plan in one year, and (2) making withdrawals from another retirement plan in the form of an annuity commencing in a year subsequent to the lump sum withdrawal. The lifetime lump sum and annuity distributions are not aggregated for purposes of determining the amount that is exempted from the excise tax. The plans are aggregated for purposes of determining the amount exempted from the supplemental estate tax.

2. The statute fails to address the issue of who pays the tax. There may be cases in which the excess benefits are paid to persons who are not beneficiaries of the deceased employee's probate estate. There should be a federal apportionment law which permits the executor to collect the 15 percent tax from the persons to whom amounts are distributable from the benefit plans. A federal apportionment law is required to eliminate any question as to whether the Retirement Equity Act prevents apportionment of

the tax under state apportionment laws or the decedent's will to the beneficiary of the plan where the beneficiary is the employee's spouse.

3. The exclusion of death benefits from the 15 percent tax made by the proposed Technical Corrections Act of 1987 will create an incentive to invest overfunded plans in life insurance. A statutory rule may be useful to determine how much life insurance may be permitted under the incidental death benefit rule.

4. The proposed Technical Corrections Act of 1987 permits a spouse to avoid or postpone the new 15 percent supplemental estate tax by electing to be treated as if the spouse were the employee. This election would permit the spouse to postpone the tax either by rolling over the benefits to an IRA or by postponing distributions from the plan. The legislative language is unclear as to whether a partial election is allowed. If a partial election is allowed, the spouse may elect to be treated as the employee only to the extent of the amount which would otherwise be subject to the 15 percent estate tax. A partial election would permit the spouses to use two exemption amounts in a manner analogous to the way spouses may double the benefit afforded by the unified credit and the exemption from generation skipping tax.

5. The election referred to in Comment 4 is only available if the spouse is the beneficiary of all but a de minimis portion of the plan benefit(s). It should be clarified that amounts payable under a QDRO are disregarded for purposes of determining whether the spouse is the beneficiary of all but a de minimis portion of the benefits, enabling the spouse to make the election to be taxed as if the spouse were the employee.

6. The 15 percent estate tax may be imposed with respect to plans that are payable only in the form of an annuity. The tax on such an annuity may exceed the cash distributable before the tax due date, thereby creating, or worsening, a liquidity problem for an estate. The statute should incorporate provisions for deferred payment of the tax

where the plan benefits are not payable in a lump sum and the tax is apportioned to the beneficiary of the plan. One way to do this would be to extend the election allowed to spouses to other beneficiaries. Alternatively, Section 6166 should be extended or construed to cover the newly imposed estate tax.

7. The Technical Corrections Act should clarify the application of Section 691(c) to the new estate tax, as was the intent according to the General Explanation of the Tax Reform Act ("Blue Book").

8. The time within which to make an election to apply the grandfather rules for benefits accrued prior to August 1, 1986 should be extended to give taxpayers more time to study and understand the new law. Moreover, the determination whether to elect grandfathering depends in part upon the discount factors used to value annuities, which have not yet been determined. The time to make the election should not pass before the discount factors are published.

Clarification of the procedure for making the election is needed. Is the election made on an income tax return or an excise tax return? If the employee dies prior to making the election, is the election made by his or her executor on the decedent's estate tax return? If an employee lives in a community property jurisdiction, is the election made only by the employee or must the employee's spouse join in the election?

9. The statute defines "qualified employer plan" as including any plan or contract which "at any time" was determined to be qualified. Therefore, distributions from plans which have lost their status as qualified plans are subject to Section 4981A. The statute should exempt from excise tax (and the supplemental estate tax) distributions from plans to the extent that the amounts distributed were previously includable in the employee's gross income. For example, amounts that were taxed as constructively received in a prior year should not be subject to the excise tax under

Section 4981A in the year in which the amounts were actually received or subject to the supplemental estate tax if the amounts were not actually distributed prior to death.

10. If the spouse of the employee predeceases the employee, are the spouse's interests under the community property laws or under the Retirement Equity Act subject to the supplemental estate tax? If the employee predeceases his or her spouse, the proposed Technical Corrections Act clarifies that the value of the decedent's interest in his or her plans is determined without regard to community property laws, but the proposed statute does not address the issue of whether the value of the surviving spouse's rights under the Retirement Equity Act may be subtracted in determining the value of the decedent's interest in the plan.

11. The statute should prevent multiple application of the supplemental estate tax to the same plan. If an employee dies and the supplemental estate tax is imposed, the supplemental estate tax should not again be imposed if the beneficiary of the plan dies prior to withdrawing the plan benefits. If the tax is imposed again, a credit should be allowed.

12. The Joint Committee's Description of the Technical Corrections Bill of 1987 at page 135 states:

> Under the bill, the operation of community property laws is disregarded in determining the amount of aggregate annual distributions subject to the excise tax. Thus, just as a nonemployee spouse's interest in an employee spouse's pension benefit is not taken into account in determining the taxable income of an employee upon distribution from or under a qualified plan, a nonemployee spouse's interest in such distributions is also disregarded in determining aggregate annual retirement distributions subject to the excise tax.

The premise stated in the second sentence is not correct. The non-employee spouse in a community property jurisdiction would be taxable for income tax purposes on his or her community property share of retirement plan distributions. Notwithstanding this fact, the aggregation rule is necessary to avoid inequitable treatment of taxpayers in common law jurisdictions.

13. Since it is the policy of the Retirement Equity Act to encourage joint and survivor annuities, the supplemental estate tax should be imposed only on the excess of the value of the plan benefits over the value of a joint and survivor annuity rather than a single life annuity.

14. The decedent's estate is not required to file an estate tax return if the estate does not exceed $600,000. A supplemental estate tax might nevertheless be due. The statute does not address the return filing requirements to report this tax.

15. While some of the significant problems with the original grandfather rule have been reduced by the provisions of the Bill, we continue to question the wisdom of an election, both as to excess retirement distributions and excess retirement accumulations. The grandfather rule should be nonelective. The election is still required to be made on a return with respect to a year before 1989. This appears to impose undue hardship on the electing taxpayer for the following reasons: (a) he has no way of appreciating the influence of the investment experience of the funds relating to his benefit; (b) there is no provision for adjusting the grandfather amount on account of a benefit reduction after the election is made; (c) the election will have an effect upon retirement benefits that may be added after the election is made; and (d) the election mechanism adds elements of complexity to an effort supposedly intended to simplify the tax laws.

16. The many objections that have been expressed as to using August 1, 1986 as the effective date of the grandfather provision have not been answered by the provisions of the Bill. In the case of a defined contribution plan, there will have to be a special valuation of the assets and account will have to be taken of the allocations of earnings and forfeitures accruable as of the valuation date. In the case of a defined benefit plan, an actuarial computation will be required. If a protective election is made or the computational

basis for the election is questioned, it may be several years after 1986, when the record is obscured by age, that the computations will need to be checked. We should favor the last day of the plan year that occurs on or after July 31, 1986 as the accrued benefit date.

17. The addition of new Section 4980A(d)(5) is an improvement, but introduces some problems as it is presently drafted. The provision for the surviving spouse to make the election should be changed to require the executor to make the election when directed by the surviving spouse to do so. Also, it is not clear that the benefit of the decedent's grandfathered amount inures to the surviving spouse when an election has been made. In addition, "as if such interests were the spouse's" in new Section 4980A(d)(5)(A)(ii) is not fully explained. Finally, if a portion of the benefit with respect to which a spousal election has been made is grandfathered, there is no provision for allocating the grandfathered amount to the de minimis share.

Respectfully submitted,

Ellen K. Harrison, Esq.
Cecil A. Ray, Jr., Esq.
Daniel C. Knickerbocker, Esq.

COMMENTS OF AMERICAN COLLEGE OF PROBATE COUNSEL, ESTATE and GIFT TAX COMMITTEE, and EMPLOYEE BENEFITS in ESTATE PLANNING COMMITTEE, WITH RESPECT TO THE PROPOSED TECHNICAL CORRECTIONS ACT OF 1987 -- S. 1350

July 20, 1987

I. Section 111B(g), Amendments related to Section 1172 of the Reform Act -- Section 2057 of the 1986 Code.

The enactment of section 2057 of the Internal Revenue Code of 1986 providing for an estate tax deduction with respect to the sale of employer securities by the executor of an estate to an employee stock ownership plan ("ESOP") or an eligible worker-owned cooperative ("EWOC") creates unwarranted complexity in the administration of decedents' estates. The availability of such a deduction is difficult to justify on tax policy grounds. If Congress desires to encourage the establishment and growth of ESOPs and EWOCs there should be better methods than tinkering with the estate tax system. The Committee recommends that section 2057 be repealed prospectively only because the Committee believes that even though the section should not have been enacted in the first place, any change in a provision of the transfer tax laws on which taxpayers may have relied should not be repealed or altered retroactively to the disadvantage of the taxpayer. This position is based not only on Constitutional grounds but also on grounds of simple fairness. This recommendation of the Committee was approved by the Board of Regents of the American College of Probate Counsel at its annual meeting in February of 1987.

II. Section 111A(g) -- Section 1133 of the Reform Act -- Section 4980A (as redesignated by the Bill) of the 1986 Code.

Without intending to comment on the desirability or undesirability of the enactment of an excise tax on "excess distributions from qualified retirement plans," it is clear that section 4980A, as enacted by section 1133 of the Reform Act, requires considerable technical correction, especially with respect to the operation of the additional estate tax provided under section 4980A(d) if the tax is to be administerable. While many of the problems have been corrected under the Technical Corrections Bill, not all have and we believe that some of the amendments made by the Bill require clarification or correction as follows:

1. Mitigation of Double Taxation -- The regular estate tax provisions should be amended to provide for a deduction from the gross estate for the amount of any additional tax imposed by section 4980A(d). If the decedent had received all of his distributions during his lifetime, the amount of the 15% excise tax on such distributions would have resulted in the reduction of the taxpayer's gross estate as a result of such tax payments or the existence of a liability therefor on date of death. Since the obvious purpose of the additional estate tax under section 4980A(d) is to equalize the liability with respect to a taxpayer who dies before receiving all of the excess distributions, equal treatment requires the allowance of a deduction of the excise tax for regular estate tax purposes. The allowance of such a deduction under section 2053 would appear to be a more appropriate provision for the mitigation of double taxation than the allowance of a deduction for income tax purposes under section 691(c) as indicated by the Joint Committee on Taxation explanation of the Reform Act.

2. Spousal Election -- The provisions of section 111A(g)(5) permitting a spousal beneficiary to defer the imposition of the additional estate tax by treating the decedent's interests and any retirement distribution attributable to such interests as if such interests were the spouse's is a great improvement, eliminating a number of the cash flow and marital deduction problems created by the section as originally enacted. However, the requirement that no one other than the spouse receive more than a de minimis portion of the interests (with the term "de minimis" meaning one percent according to the Joint Committee Staff explanation), may create an unnecessary trap for the unwary. The interests of the Treasury would appear to be equally served by imposing the additional estate tax on any amounts, however large, received by persons other than the spouse. To accomplish this, it would be only necessary to subtract (i) the amount of tax which would be imposed if the deferred excess retirement accumulation had been taxed as the sole excess retirement accumulation from (ii) the tax which would be imposed if there were no deferral. Thus, the government would be receiving the incremental tax which would be caused by the portion going to persons other than the spouse, and would later receive the balance of the tax if, as and when the spouse received distributions or died.

3. Date of Grandfathering -- The use of August 1, 1986 as the grandfathering date will raise administrative problems for many plans. In order to apply the grandfathering election, as the statute is currently worded, affected plans will have to be valued, and allocation procedures followed with respect to the accrued benefits of plan participants, as of August 1, 1986. In the experience of the members of the committee, very few, plans are likely to have procedures established for valuing plan assets and making allocations as of that date, thus requiring a plan fiduciary to institute a special valuation and allocation procedure simply for purposes of the grandfathering election. Such special procedures may, in many instances, be burdensome and expensive to implement as compared with using the normal valuation date for the plan, or at least a valuation date which is likely to coincide with that followed by many plans or to be relatively convenient to implement. To this end, amending the Code to provide a base date for the grandfathering election of December 31, 1986, would be much more consistent with the accounting and valuation procedures followed by most plans. A possible convenient administrative alternative might be to permit an election to use the closest normal valuation date utilized by the plan for normal administrative purposes. Any potential for abuse which may have been perceived at the time this provision was initially considered has, of course, been eliminated by the passage of time.

4. Qualified Domestic Relations Orders -- Further clarification is needed with respect to the interplay of the grandfather election rule with qualified domestic relations orders. Is the grandfathered amount required to be allocated between the participant and his or her spouse on some proportionate basis, or could, for example, all of the grandfathered portion be awarded to the spouse?

III. Section 114(f) -- Amendments related to Section 1431 of the Reform Act -- Chapter 13 of the 1986 Code.

Again, without commenting on the desirability as a matter of tax policy of the enactment of chapter 13 of the Internal Revenue Code, it is the opinion of our Committee that assuming the desirability of such enactment there is great need for technical correction of the provisions as enacted by the 1986 Reform Act, and further technical correction with respect to the provisions contained in H.R. 2636, although it is also the opinion of our Committee that H.R. 2636 has made a number of needed corrections. A number of the members of our Committee are also members of committees of the Section of Taxation and of the Section of Real Property, Probate and Trust Law of the American Bar Association, which committees are also submitting comments. To the extent that those comments are not inconsistent with the separate specific comments made herein, we would endorse the comments of those committees. The fact that these comments do not specifically address any issue under chapter 13 of the Internal Revenue Code should not be construed as an indication that our Committee endorses the existing provisions.

1. Support Obligations -- The provision of section 114(f)(7) of the Bill adding section 2652(c)(3) to the 1986 Code is desirable. However, if it is intended to avoid creation of a trap for the unwary in the drafting of instruments, it may not achieve its intended result. It is subject to the interpretation that a broad encroachment provision in a trust instrument permitting use of trust funds for the "health, education, support or maintenance of a beneficiary" would constitute an express provision for satisfaction of the obligation of support, even though the possibility of the use of the funds to satisfy such obligation would be so remote as to be negligible. A better solution might be to have the consequence depend upon actual use of funds of the trust for the proscribed purpose.

2. Gifts to Existing Trusts -- Clarification is needed in the computation of the applicable fraction where a partially non-taxable gift is made to an existing trust. While the proper interpretation of the provisions of section 2642(d) should be to include in the denominator of the fraction only the taxable portion of the gift, "any possible contrary interpretation could easily be eliminated by amending section 2642(c)(2)(A) adding at the end thereof the words "or subsection (d)(2)(B)."

3. Payment of Estate Tax with respect to Elective QTIP -- The Technical Corrections Act of 1987 does not deal with a question that has been bothering a substantial number of estate planners with respect to what constitutes an addition to an exempt trust for generation-skipping transfer tax purposes. The precise situation arises where an allocation of a portion of the generation-skipping transfer tax exemption is made to a qualified terminable interest property trust and provision is made to pay the federal estate tax attributable to the qualified terminable interest property trust being included in the estate of the surviving spouse from the surviving spouse's other assets so as to preserve the generation-skipping transfer tax exemption to the extent that it has been allocated to the "QTIP trust." The payment of the federal estate tax attributable to the qualified terminable interest property trust should not constitute a constructive addition to the trust which is otherwise exempt from generation-skipping transfer tax.

4. Single Trust not to be treated as Multiple Trusts -- The effect of the addition by section 114(f)(15) of the new sentence (which is arguably more than a technical correction) at the end of Section 2654(b) is of much broader scope than the annual exclusion problem addressed by the Joint Committee Staff in its description of this provision. Not only will this require grandparents to establish separate trusts for their annual exclusion gifts and strictly limit the value of the

gifts to the exclusionary amount, but it will in many cases require the creation of multiple testamentary trusts for purposes of an effective allocation of the $1 million exemption. The result may be to preclude authorization for the subdivision of generation-skipping trusts and the allocation of the exemption so as to produce one wholly exempt trust and one wholly taxable trust, thereby putting a premium on complicated drafting and increasing administration costs through the use of multiple trusts of a smaller size. On the other hand, if the donor or testator chooses not to use multiple trusts, this provision will create administrative nightmares for the trustee.

IV. Section 114(g) -- Amendments related to Section 1433 of the Reform Act.

1. Effective Date Changes -- Our Committee strongly opposes the provision of section 114(g)(2)(D) which retroactively changes the effective date insofar as persons who were competent on September 25, 1985 but became incompetent prior to October 22, 1986. The provision of the Tax Reform Act of 1986 was perfectly clear that a person who had executed a Will prior to the date of enactment and was incompetent to change the same on the date of enactment and at all times thereafter would not be subject to the tax by reason of provisions in such Will. This provision was included in the original Bill, H.R. 3636, so that any individual knowledgable about the provisions of the Bill would have been lead to believe that he would have until the date of enactment to change the provisions so as to avoid the imposition of the generation-skipping tax. Changing the words "on the date of enactment" to "September 25, 1985," in paragraph (2) of §1433(b) is extremely inequitable since, as a practical matter, no one could know for certain what would happen in the generation-skipping transfer tax area until the statute was actually enacted. A person who was not incompetent on September 25, 1985, but became incompetent before the date of enactment on October 22, 1986, would be penalized for not revising a Will or a funded revocable trust in anticipation of legislation which might not have ever been enacted had the Senate version of the Tax Reform Act of 1986 been adopted. The retroactive effect of such a provision is of questionable constitutionality. In addition, there seems to be no justification for the disparity in treatment in this regard, of persons who died before January 1, 1987, even if they changed their Wills between September 25, 1985 and October 22, 1986, and those who were incompetent but had the misfortune of living beyond January 1, 1987, notwithstanding that such person's incompetency occurred after September 25, 1985 and before October 22, 1986.

2. Grandchild Exemption -- In section 114(g)(3) of the Bill, dealing with the $2 Million Grandchild Exemption the Bill would provide three statutory standards to qualify a trust for the benefit of a grandchild as a transfer "to" such grandchild. One of the standards -- the requirement that, after the grandchild reaches age 21, the trust must pay all income currently to the grandchild -- seems unnecessary from the point of view of giving the grandchild a vested interest and undesirable from the point of view of limiting a grandparent's legitimate planning objective to give the trustee discretion over distributions of income and principal to the grandchild during the continuance of the trust. The two other statutory requirements -providing that the grandchild be the exclusive beneficiary and that trust assets be estate tax includible -- should be sufficient. Especially in the establishment of trusts for beneficiaries of tender years, sound policy would dictate that income distributions be left to the determination of a trusted person that the beneficiary is sufficiently mature to handle the funds. Such maturity may not

be reached at age 21 in many cases. With the compression of income tax rates for trusts under the Reform Act, there is already a tax incentive to make income distributions. The decision of the grandfather or grandmother to postpone income distributions will be non-tax oriented.

If the income distribution requirement is retained, it should be retained only for transfers after the date of enactment of the Bill. It should be noted that the Instructions to the Form 709 United States Gift (and Generation-Skipping Transfer! Tax Return Rev. January 1987), issued by the Department of the Treasury, Internal Revenue Service, contained the following instruction which is inconsistent with this requirement and which might well have misled taxpayers:

"If you transferred real property to your grandchild in trust, you may only claim a grandchild exclusion if the property transferred will be included in the grandchild's gross estate for Federal estate tax purposes. For example, this requirement is satisfied if you gave your grandchild a general power of appointment over the property transferred to a trust."

3. Grandfathered Instruments -- Section 114(g)(2) of the Bill would properly equate a revocable trust to a Will by grandfathering "transfers under" either form of instrument executed before date of enactment if the decedent died before January 1, 1987. The Bill still does not adequately deal with the situation where the decedent created a QTIP trust under either a Will or revocable trust signed before date of enactment but died prior to January 1 leaving a surviving spouse. The Bill should be further clarified to provide that the QTIP (including one over which the surviving spouse has a limited testamentary power of appointment) will be treated as a grandfathered "transfer under" either form of instrument. In the absence of clarification, there would be considerable uncertainty as to the application of the various Chapter 13 rules regarding the identity of the transferor (e.g., Section 2652(a) of the Code, Section 114(f)(10) of the Bill), valuation (e.g., Section 2642(b)(4) of the Code) and partial grandfathering of trust assets (Section 114(g)(3) of the Bill adding Section 1433(b)(4)). If there is no clarification on the point, the decedent's personal representative would seem to be in the anomalous position of deciding whether it is necessary to make an election under Section 2652(a)(3) -- an election which arguably should not be available to him by reason of the wording of Section 1433 -- to treat the decedent as the transferor of the QTIP for grandfathering purposes.

4. Definitions for Section 1433(b)(3) of the Reform Act -- Our committee believes that the new Section 1433(b)(3) proposed by Section 114(g)( ) of the Bill should be changed by changing the semi-colon to a period and deleting the portion thereafter. There is no reason why the definition of a grandchild of the transferor, for purposes of the predeceased child exception for purposes of Section 1433(b)(3) should not be identical. Transfers to the grandchildren of the transferor's spouse or former spouse should be included as those eligible for the application of Section 1433(b)(3) particularly in view of the fact that the provision sunsets on January 1, 1990.

V. <u>Additional Technical Corrections in The Treatment of Transfers of Plan Benefits Between Spouses</u>.

A. The law should be clarified or amended to permit an effective "Transfer" of an Employee's interest in Plan Benefits for State Law purposes

1. <u>The Problem</u>. Section 401(a)(13) and the Retirement Equity Act inhibit the ability of a spouse (particularly a nonemployee spouse in a community property state) to transfer an interest in qualified plan benefits in a manner which is effective for state property law purposes. Both provisions contain exceptions for transfers which are made pursuant to qualified domestic relations orders ("QDROS"), defined under Section 414(p).

2. <u>QDRO Definition</u>. Section 414(p) defines the terms "domestic relations order" and "qualified domestic relations order" in such a way as to make it unclear whether a probate order otherwise meeting the requirements of Section 414(p) constitutes a QDRO. The section should be amended to make it clear that such probate orders do, in fact, constitute QDROs so that upon the death of a spouse it would be clear that the spouse could transfer his or her interest in plan benefits in the same manner that other property is transferred.

3. The QDRO rules prohibiting cashouts of over $3,500 should be relaxed for probate QDROs, so that the beneficiary of a deceased nonemployee spouse's estate can elect to receive whatever benefit is allowed under the employee spouse's plan following the nonemployee spouse's death in a community property state.

B. <u>The Marital Deduction</u>

Section 2056 should be amended to make it clear that any benefit under a qualified or nonqualified plan, IRA or other retirement arrangement may qualify for the federal estate marital deduction treatment. Furthermore, Section 2056 should be amended to make it clear that an interest in such benefits passing (presumably pursuant to the type of probate QDRO discussed in the proceeding paragraph) from one spouse to another will qualify <u>in full</u> for the deduction at the first spouse's death, and that any residual amount remaining in the plan or IRA at the surviving spouse's death will be included in such spouse's estate in the same manner as is currently provided with respect to qualified terminable interest property under Sections 2056(b)(7)(B) and 2044. Amendments to this effect would probably be required in both Sections 2056 and 2044. Such clarification should also address the valuation of the marital deduction at the first spouses death. For example, the Internal Revenue Service currently uses a 10% discount rate for valuing benefits paid in annuity form, based on the amount of the initial payment, so that if payments increase over time, the full marital deduction may not be available to the first spouse's estate. This is particularly true since a surviving spouse is not required to begin receiving payments until age 70-1/2 under Sections 401(a)(9)(b)(iv) and 408(d)(3), may elect to receive payments over his or her life expectancy (recalculated annually), and will in most cases have a relatively long life expectancy. Under the Proposed Regulations §20.2056(b)-7(c)(2) and 7(e), Examples 8-10 and 12-14, certain types of distribution arrangements to a surviving spouse will not qualify in full for the marital deduction. In short, the calculations made with respect to the marital deduction under Section 2056 should be made on the same basis as the income tax requirements under the other sections of the Code. Finally, Section 2056 should be clarified to the effect that an interest in qualified or nonqualified plan benefits, or an IRA, passing to a surviving spouse will not be deemed a terminable interest, regardless of the form of benefits elected. If for example, in a community property state, the interest of a nonemployee spouse were to pass to the employee spouse under a probate QDRO, it should be clear that the interest will not be a non-qualifying terminable interest even though the interest may be subject to, e.g., the rights of a surviving second spouse under the Retirement Equity Act.

C. Gift Tax Issues

The Tax Reform Act of 1988 repealed Section 2517 and enacted Section 2503(f), both of which dealt with the gift tax implications of benefit payments from qualified plans. The Retirement Equity Act of 1984 had previously imposed a requirement that most retirement plans provide for a joint and survivor annuity form of benefit for any married participant. The participant may have the ability to waive such joint and survivor annuity, as long as the participant's spouse consents to the waiver. Section 2503(f), added by the Tax Reform Act of 1986, clarifies that such a waiver, and in particular the consent to such a waiver by the nonemployee spouse, will not constitute a transfer for gift tax purposes. Unfortunately, this section does not address the reverse situation--what happens when a participant retires and does not waive the joint and survivor annuity requirement (or the spouse does not consent)? Prior to the Tax Reform Act of 1986, Section 2517 made it clear that where a participant receives a smaller annuity during his lifetime to enable his spouse to receive a survivor annuity, the election to do so would not, in general, constitute a gift. The repeal of Section 2517 causes the surviving spouse's interest in a joint and survivor annuity from a qualified plan to be a taxable gift. The internal Revenue Service has issued a number of rulings in a similar context dealing with the Civil Service Retirement Spouse Equity Act of 1984, including private letter rulings 8639075, 8647004 and 8708008. In each instance, the Service has taken the position that the "gift" of the value of the survivor annuity did not qualify for either the annual exclusion or the marital deduction.

The anomalous result produced by the repeal of Section 2517 and the enactment of Section 2503(f) is that, from a tax standpoint, married participants will be encouraged to waive the joint and survivor annuity and to persuade their spouses to consent to such waivers, in order to avoid making a transfer subject to the gift tax at retirement. In all likelihood, this is precisely the opposite result from that which was intended by Congress in enacting the Retirement Equity Act of 1984 and Section 2503(f). This matter should be corrected so that, at a minimum, the "gift" which occurs when a participant does not waive the joint and survivor annuity (or the nonemployee spouse declines to consent) qualifies in full for the marital deduction. This is a matter which probably should be addressed in connection with Section 2523, dealing with the gift tax marital deduction. The College would suggest that a provision be added similar to that now found in Section 2523(d) dealing with the creation of joint interests, to the effect that any retained interest of the donor in the joint and survivor annuity which exists by virtue of the fact that the donor's spouse (the participant) may survive the donee spouse will not be deemed to be an interest retained by the donor for himself.

VI. Technical Correction of Sections 2035 and 2038 of 1986 Code to clarify Congressional intent as contrary to result of Technical Advice Memorandum ("TAM") 8609005.

In 1986, while the Reform Act was pending, the Service issued a TAM holding that a gift made from a lifetime revocable trust within three years would be brought back under section 2035 into the grantor's estate for estate tax purposes even though a similar gift made by the grantor directly would not -- a triumph of form over substance. A revocable trust is merely an alter ego for the grantor. It normally is and hould be treated no differently for income, gift and estate tax purposes than if the assets of the trust were owned outright by the grantor without any trust. It is only a method of providing for convenient management of property during life and as a substitute for probate. TAM 8609005 should be overruled legislatively. The correction could be made simply by adding the following parenthetical clause at the end of section 2035(d)(2) of the 1986 Code:

> "(except under sections 2036, 2037 and 2038 with respect to a transfer from or a release of any interest in or power over a revocable trust)."

with a corresponding modification adding at the end of the first sentence of each of Sections 2038(a)(1) and (2)the following:

> "(except a transfer from or a release of any interest in or power over a revocable trust)."

A more detailed memorandum of the problem created by the TAM 8609005 and the proposed solutions is available on request.

The American College of Probate Counsel
Fiduciary Income Tax Committee

Summary

The following is a summary of comments made by the Fiduciary Income Tax Committee of the American College of Probate Counsel (the "Committee") with respect to S.1350, the Technical Corrections Act of 1987:

A. The Committee supports the amendment of Code §67(e) with respect to the determination of adjusted gross income in the case of estates and trusts,

B. The Committee recommends clarification of Code §674(c) where the grantor's spouse is a co-trustee with an independent trustee,

C. The Committee recommends an amendment to Code §163(h)(2) to permit the interest on the delayed payment of pecuniary bequests to be deductible,

D. The Committee recommends an amendment to Code §67(b) to clarify the treatment of Code §67 deductions in the hands of beneficiaries who succeed to such deductions under Code §642(h),

E. The Committee recommends an amendment to Code §642(h) to permit beneficiaries succeeding to the property of a terminated estate or trust to succeed to suspended passive activity losses and credits,

F. The Committee recommends an amendment to Code §6654(l) to make the treatment of revocable trusts consistent with the treatment of estates with respect to estimated taxes,

G. The Committee recommends an amendment to Code §643(g) (1) and (2) to permit the election with respect to payments of estimated tax treated as paid by the beneficiary to be made on a timely filed return and to permit an estate to make such election also.

Comments With Respect To
S. 1350, The Technical Corrections Act Of 1987

A. Section 101(f)(3); amendment of Section 67(e).

The Fiduciary Income Tax Committee of the ACPC supports this section of the Bill. We understand that the section has given rise to some controversy, and, therefore, believe it is useful to articulate our support of the provision.

Section 67 of the 1986 Code provides that miscellaneous itemized deductions are subject to a floor of 2% of adjusted gross income. The rule also applies to estates and trusts, although subject to a special exception for certain administrative expenses.

Under the existing law, if both the estate or trust and a beneficiary to whom distributions are being made have miscellaneous itemized deductions of the type subject to the 2% floor, the disallowance under Section 67 will be greater than the disallowance would have been if the income and deductions of the estate or trust and the beneficiary had all belonged to a single taxpayer. The reason for this result is that where distributions are made to a beneficiary, the adjusted gross income of the estate or trust which is taken into account in applying the 2% floor at the fiduciary level is, with minor adjustments, also taken into account in determining the beneficiary's 2% floor, since the beneficiary will include in his gross income under Section 652 or Section 662 of the 1986 Code distributions of estate or trust income.

Section 101(f)(3) of the Bill cures this problem by amending Section 67(e) of the 1986 Code to provide that the distributions deduction under Section 651 and Section 661 of the 1986 Code will be applied in determining the adjusted gross income of an estate or trust. Accordingly, to the extent that a distributions deduction is available under Section 651 or Section 661, the income which is passed out to the beneficiary will not be taken into account in determining the 2% floor at the estate or trust level.

This is a very practical solution to the potential double disallowance problem.

To the extent that any questions may arise with respect to the allocation of miscellaneous itemized deductions between a beneficiary and an estate or trust, it is to be noted that Section 101(f)(4) of the Bill amends Section 67(c) of the 1986 Code by granting the Secretary of the Treasury regulatory authority which appears to be broad enough to permit allocation of such deductions among estates and trusts and their beneficiaries.

B. Clarification of Section 674(c).

Section 674(a) of the 1986 Code provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus of the income therefrom is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.

Section 674(c) of the 1986 Code provides an exception to Section 674(a) with respect to "... a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, <u>none of whom is the grantor</u>, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor - [to make certain distributions and payments] ...." (Emphasis added.)

For purposes of applying Section 674(c), it is not clear whether the exception applies where the spouse of the grantor is a co-trustee with an independent trustee. It would appear that a technical correction is necessary to clarify that "none of whom is the grantor" should be construed to include "none of whom is the grantor's spouse."

It is to be noted that Section 114(a)(2) of the Bill would amend Section 675 of the 1986 Code to clarify that a loan to a grantor's spouse would be treated as a loan to the grantor. The absence of a similar technical correction with respect to Section 674(c) might give rise to a negative implication that having the spouse of a grantor act as trustee was not intended to be the equivalent of the grantor acting as trustee.

In order to be consistent with the apparent intention of Congress that a grantor's spouse will be treated as the grantor for all purposes connected with Subpart E, it is recommended that Section 674(c) of the 1986 Code be amended to add the words "or the grantor's spouse (within the meaning of Section 672(e)(2))" after the words "... none of whom is the grantor."

C. Interest on pecuniary bequests.

In general, income earned on assets of an estate or trust is taxable only once. If no distributions (other than distributions subject to the exclusions of Section 663(a) of the 1986 Code) are made from an estate or complex trust to beneficiaries during the taxable year, such income is taxable to such estate or trust. To the extent distributions are made to beneficiaries during the taxable year, such estate or trust is entitled to a distributions deduction under Section 661 and the beneficiary takes in income under Section 662 of the 1986 Code. In effect, the taxable income is allocated between the taxpayers but is taxed only once.

Where payment of a pecuniary bequest is delayed, the laws of some states provide that the legatee is entitled to "interest" on the delayed payment. In Rev. Rul. 73-322, 1973-2 CB 44, the Service ruled that such statutory interest was truly interest and was not subject to the application of the distributions deduction under Section 661. This result had limited economic effect in 1973, since the estate was entitled to an interest deduction which compensated for its loss of a distributions deduction.

However, with the advent of limitations to the deductibility of interest under the Tax Reform Act of 1986, late payment of pecuniary legacies may result in double taxation of income if relief is not provided by technical corrections.

The income earned on the assets which are the subject of the pecuniary legacy will be taxable to the estate, but the estate will receive no interest deduction for the payment of such "interest" to the legatee, unless such interest can be characterized as "investment interest" under Section 163(h)(2)(B) of the 1986 Code or some other exception to the definition of "Personal Interest" under Section

163(h)(2) of the 1986 Code. Nevertheless, the legatee will pay tax on the "interest" received.

Since late payment of pecuniary legacies is often necessary (e.g., because of open estate tax issues), estates with pecuniary bequests may be subject to higher income taxes than estates limited to residuary bequests, and the deductibility of payments will vary state to state depending upon whether, and the extent to which, such statutory interest is imposed.

A similar result might obtain in the case of a revocable trust which is used as a will equivalent, or in the case of some other form of trust, such as a QTIP trust, which is required to make pecuniary distributions on the death of the decedent or the decedent's spouse.

To correct this problem, it is recommended that a new subparagraph (F) be added to Section 163(h)(2) of the 1986 Code, to read as follows:

> "(F) any amount payable as interest by an estate or trust by reason of delayed payment of any bequest, legacy, or other required distribution."

D. Treatment of Section 67 upon termination of estates and trusts.

During the administration of an estate or trust, deductions for costs which are paid or incurred in connection with the administration of the estate or trust, and would not have been incurred if the property were not held in such estate or trust, are deductible from gross income in computing adjusted gross income pursuant to Section 67(e) of the 1986 Code. These costs are accordingly not subject to the 2% floor on miscellaneous itemized deductions.

On termination of an estate or trust, to the extent that deductions (with minor exceptions) for the last taxable year of the estate or trust exceed gross income, such excess is allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust pursuant to Section 642(h) of the 1986 Code.

While there appears to be no reason for such excess deductions to be treated differently in the hands of beneficiaries than in the hands of the estate or trust, there is need for clarification with respect to Section 67 treatment of such deductions in the hands of beneficiaries who succeed to such deductions under Section 642(h).

It should be noted that if relief is not provided by technical corrections, executors may be forced to match these costs against estate or trust income by prepaying fees or commissions in years prior to termination or by extending the period of administration in order to maximize estate or trust income. One result may be an increase in controversies over whether administration of an estate has been unduly prolonged (See Regs. § 1.641(b)-3(a)).

It is recommended that a new subparagraph (14) be added to Section 67(b) of the 1986 Code, to read as follows:

> "(14) the deduction under section 642(h) (relating to excess deductions on termination of an estate or trust) to the extent that excess deductions allowable to beneficiaries under that section
>
> (i) consist of deductions for costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such estate or trust, or
>
> (ii) consist of deductions excepted from the definition of "miscellaneous itemized deductions" under subparagraphs (1) through (13) of this section 67(b)."

E. Unused passive activity losses and credits on termination of estates and trusts.

Section 642(h) of the 1986 Code allows beneficiaries succeeding to the property of a terminated estate or trust to succeed to unused loss carryovers and excess deductions. It would seem appropriate and consistent with the legislative history to have the same treatment apply with respect to suspended passive activity losses and credits.

It is recommended that Section 642(h) be amended by adding the word "or" at the end of clause (2), deleting the balance of such subsection and substituting therefor the following:

> "(3) for the last taxable year of the estate or trust disallowed passive activity loss or passive activity credit under subsections (a) or (b) of section 469,
>
> then such carryover or such excess or such disallowed passive activity loss or passive activity credit shall be allowed as a deduction or passive activity loss or passive activity credit, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust."

F. Treatment of revocable trusts and estates with respect to estimated taxes.

For state law and other administrative reasons, many practitioners use revocable trusts as "will equivalents" in estate planning. Where a trust is fully revocable by the grantor at the time of his death, there appears to be no policy reason to treat the revocable trust differently than an estate after the grantor's death with respect to estimated taxes.

It is recommended that Section 6654(l) of the 1986 Code be amended to read as follows:

> "(l) Estates and Trusts. -- This section shall apply to --
>
> (1) any trust other than a trust, after the death of the grantor, which was revocable by the grantor at the time of his death, and
>
> (2) any estate, and any trust, after the death of the grantor, which was revocable by the grantor at the time of his death, with respect to any taxable year ending 2 or more years after the date of the decedent's or the grantor's death."

G. Section 114(d)(3); amendment of Section 643(g).

Section 643(g)(2) of the 1986 Code provides that the election of a fiduciary to treat excess estimated tax payments as being made by the beneficiary must be made on a return filed on or before the 65th day after the close of the taxable year.

Section 114(d)(3) of the Bill amends Section 643(g)(2) to provide that the election must be made on or before the 65th day after the close of the taxable year, but not necessarily on a tax return.

The proposed technical correction fails to address the major problem of the statute, namely that 65 days will often not be enough time for the fiduciary to analyze whether, and to what extent, an election should be made.

While it is true that 65 days is the time provided by statute for making distributions which may be considered as having been made on the last day of the preceding taxable year under Section 663(b) of the 1986 Code, it is not a sufficient time for a fiduciary to finalize the fiduciary income tax computations necessary to make an intelligent election under Section 643(g) of the 1986 Code. The Section 663(b) election is based primarily on a computation of income, which should be easily determinable within the time frame. The Section 643(g) election, on the other hand, requires a final computation of the fiduciary income tax, which will include consideration of such complex issues as alternative minimum tax, income and deductions with respect to passive investments, and income and deductions with respect to partnerships and other entities which may not have provided the estate or trust with sufficient tax information within the time frame.

It is recommended that in lieu of the amendment proposed in the Bill, Section 643(g)(2) of the 1986 Code be amended to read as follows:

> "(2) TIME FOR MAKING ELECTION. -- An election under paragraph (1) shall be made only on a timely filed return of the tax imposed by this chapter for the taxable year."

Further, there seems to be no reason why an estate should not be entitled to use Section 643(g) once it is subject to payment of estimated taxes.

It is recommended that Section 643(g)(1) of the 1986 Code be amended to read:

> "(1) IN GENERAL. -- In the case of a trust, or in the case of an estate with respect to any taxable year ending two or more years after the date of the decedent's death --"

Conforming amendments should be made to substitute "trustee or executor" wherever "trustee" appears.

In the event that the Code is amended to provide that revocable trusts will be treated in the same manner as estates in that they will be subject to estimated taxes only with respect to taxable years ending two or more years after the grantor's death, further conforming amendments should be made.

THE ACPC FIDUCIARY
INCOME TAX COMMITTEE

STATEMENT OF
THE AMERICAN COUNCIL OF LIFE INSURANCE
ON THE PROVISIONS OF
S. 1350, THE TECHNICAL CORRECTIONS ACT OF 1987
JULY 21, 1987

The American Council of Life Insurance urges that the following three issues be resolved in the technical corrections to the Tax Reform Act of 1986:

1. Transition rule for market discount bonds. S. 1350 would revise the capital gains transition rule for market discount bonds held by life insurance companies to make it applicable to all life insurance companies at a 31.6% tax rate. The ACLI strongly supports adoption of the generic approach to a transition rule but urges that the tax rate be lowered to 29.1%.

2. Alternative minimum tax. It is urged that a technical correction be made to the corporate alternative minimum tax provisions to clarify that certain exceptions applicable under the normal income tax computation as respects corporate-owned annuities also apply in computing the adjusted current earnings preference.

3. Non-discrimination requirements for group-term life insurance plans. It is urged that a technical correction be added, if deemed necessary, to make clear that the two long standing methods for structuring employee contributions to group-term life insurance plans will continue to qualify under the new non-discrimination rules for these plans in Section 89.

In each case, a supporting memorandum is attached.

GENERIC CAPITAL GAINS GRANDFATHER CLAUSE
FOR MARKET DISCOUNT BONDS HELD BY
LIFE INSURANCE COMPANIES--
TAX RATE SHOULD BE NO HIGHER THAN 29.1%

Summary of Proposal: The technical corrections bill (S. 1350) would expand the scope of the capital gains grandfather clause for certain market discount bonds in the Tax Reform Act of 1986 to cover all life insurance companies, instead of only a limited group of 15 companies. (Section 110(a)(2) and (3)). However, the grandfathered tax rate would be increased from 28% to 31.6%, on the grounds that this increase is necessary to achieve revenue neutrality. In fact, the tax rate for this expanded provision should be set no higher than 29.1%, since at that rate, budget receipts and deficits in the February baseline would be unaffected. Thus, it is urged that the technical corrections bill be amended to reduce the expanded capital gains grandfather clause tax rate to 29.1%.

Background: The Tax Reform Act of 1986 repealed the corporate capital gains tax rate of 28% and subjected such gains to tax at the new 34% corporate ordinary income tax rate.

However, as part of its transition rules, Congress decided to allocate amounts to a grandfather clause with respect to the capital gains tax rate for market discount on existing bond portfolios held by life insurance companies (and previously grandfathered under the 1984 legislation). At the time this transition rule was being considered last fall, it was estimated that the revenue cost of a full grandfather clause (i.e., one preserving the prior 28% tax rate) for all life insurance companies would significantly exceed the amount that could be allocated to this rule. Thus, it was decided to enact a 28% provision applicable to only 15 life insurance companies.

It was estimated at that time that the cost of a transition rule for those companies would equal $120 million over the 5-year revenue estimating period. Therefore, the grandfather provision was carried in the Conference Report as a reduction of budget receipts of $120 million over the 5-year period; and it continues to be carried at that level in the February budget baseline.

The revenue estimates used in connection with the grandfather provision were, of necessity, made very quickly and based on information hurriedly compiled by a limited number of life insurance companies. In order to update the revenue figures to reflect bond sales at the end of the year and make them as accurate as possible, the ACLI, early in 1987, conducted a special survey of member companies requesting information as to market discount in bond portfolios held on December 31, 1986. The results of this survey were given to the staff of the Joint Committee on Taxation. On the basis of this updated information and its own analysis, the Joint Committee staff now estimates that the transition rule, if applied on an industry-wide basis at a 28% rate, involves a revenue loss of $146 million for the relevant 5-year estimating period.

This revised estimate is only $26 million more than the amount Congress originally agreed to spend on this issue and the amount which is carried in the February budget baseline. A generic transition rule at a 29.1% rate would produce a revenue loss equal to the original $120 million figure and would have no effect on budget receipts and deficits using the February baseline. This budget neutrality would only be threatened if the Congressional Budget Office reflects a revised estimate of the revenue cost of the grandfather provision when it updates the budget baseline in August.

<u>Position</u>: On the basis of this updated information, the market discount transition rule provided by the 1986 Tax Reform Act should be corrected to apply on an industry-wide basis at a 29.1% rate. The technical corrections bill achieves such industry-wide application but should be amended to lower the tax rate to 29.1%.

Such a transition rule is important for all life insurance companies holding market discount bonds. The gain to be realized on a market discount bond is known and fixed at the time of purchase. The after-tax value of that gain is, in turn, often used by life insurance companies in setting investment returns or in pricing contracts it enters into with customers. A grandfather provision is needed to protect existing market discount bonds from a change in the tax rate which could retroactively turn good business decisions into bad decisions.

Moreover, an industry-wide provision at a 29.1% rate would be consistent with the revenue and budget effects of the 1986 Act. As indicated, Congress originally allocated $120 million to a capital gains transition rule for market discount bonds of life insurance companies and this amount is reflected in the February budget baseline. Based on current data, a 29.1% generic provision conforms to the $120 million figure, and, therefore, would have no additional impact on budget receipts and deficits against this baseline.

The Joint Committee staff estimate of $146 million for a generic provision at 28% is made up of two components: $59 million is attributable to maintaining the current 15-company provision and $87 million is attributable to expanding the grandfather clause to apply to the remainder of the life insurance business. It has been indicated by the Staff that, to achieve revenue neutrality, the total revenue cost of a generic rule must be limited to $59 million, the current estimate of the cost for the 15 companies. According to the Staff, this can only be accomplished, in the context of a generic grandfather clause, by providing a tax rate of 31.6%, instead of 28%. This undoubtedly is the genesis of the provision in the technical corrections bill.

What this analysis ignores is the budget effects of the alternatives. As indicated, a 29.1% generic grandfather tax rate would have no additional budget impact over that presently included in the February baseline for a capital gains grandfather provision.

Proposed Amendment: In subparagraph (B) of Section 110(a)(2) of S. 1350, strike out "31.6 percent" and insert in lieu thereof "29.1 percent".

TAXATION OF INCOME ON CORPORATE-OWNED ANNUITIES UNDER THE CORPORATE ALTERNATIVE MINIMUM TAX

A new corporate alternative minimum tax was enacted as part of the Tax Reform Act of 1986. A "business untaxed reported profits" preference item was included to reach untaxed corporate income. The preference consists of a book income adjustment for taxable years beginning in 1987, 1988 and 1989 and of an adjusted current earnings adjustment thereafter.

Section 56(g)(4)(B)(iii) of the Code relates to the computation of adjusted current earnings. The provision includes in adjusted current earnings the income build-up on annuity contracts held by non-natural persons. The includible income is determined under Section 72(u)(2).

Section 72(u), also enacted as part of the 1986 Act, includes in the regular tax base the inside build-up on annuity contracts held by non-natural persons. The primary target of this provision was deferred compensation arrangements. To focus the legislation Section 72(u)(3) contains five exceptions to the general rule. These exceptions are for annuities held generally in a fiduciary capacity for another, such as annuities to fund pension plans and terminated pension plans. It was recognized that in such nominal capacity the holder normally receives no gain other than any otherwise taxable fee. (It is recognized that an immediate annuity under Section 72(u)(3)(E) could involve relatively minor amounts of economic income.)

As noted, Section 56(g)(4)(B)(iii) cross-references Section 72(u)(2) concerning income determination. However, the provision does not make clear that the exceptions in Section 72(u)(3), mentioned above, should be taken into account for adjusted current earnings purposes.

Accordingly, we urge inclusion of a technical correction to make clear that the Section 72(u)(3) exceptions apply with respect to the income to be included in adjusted current earnings under Section 56(g)(4)(B)(iii). This could be accomplished by changing the reference in Section 56(g)(4)(B)(iii) from Section 72(u)(2) to Section 72(u) with appropriate Committee report language.

The new corporate alternative minimum tax provisions were clearly intended to impose a minimum tax only on economic gain -- on corporate income not otherwise taxed. The proposed Technical Corrections Act of 1987 (S. 1350) already recognizes that the income on annuities held by a corporate employer in a fiduciary capacity for its employees should not be taxed to the employer under Section 56(g)(4)(B)(iii). (Section 107(b)(12)). This technical correction proposal applies to annuity contracts held by a corporate employer under Section 403(a) plans and corresponds to the part of the Section 72(u)(3)(B) regular tax exception that concerns a corporate holder of an annuity.

Building on this provision, the rest of the Section 72(u)(3) exceptions should also be excluded from the alternative minimum tax base. The other annuity contracts in those exceptions either do not involve a corporation holding an annuity (Section 72(u)(3)(A)), concern an immediate rather than a deferred annuity (Section 72(u)(3)(D)), or involve a corporation holding an annuity as a fiduciary. Those latter two exceptions are discussed further below.

Section 72(u)(3)(D) provides an exception, similar to that in Section 72(u)(3)(B)(iii), for deferred annuities held by the employer for the employees' benefit where they are purchased to fund the accrued obligations to employees under a terminated plan. The trustee of the plan being terminated must provide for these obligations of the plan. The purchase of dedicated deferred annuity contracts is the presently required means of funding such obligations. The existing contractual arrangements do not entitle a company to recover, from any source in the transaction, income tax it may be required to pay on the income on these annuities held for the employees' benefit.

The income from a structured settlement annuity (Section 72(u)(3)(C)) is also contractually dedicated to the benefit of the injured party. In structured settlements all distributions from the annuity received by the annuity holder administering the settlement must be paid to the injured party. Section 130, concerning such settlements, requires the payments under the annuity contract to match the required payments to the injured party.

We understand that the National Structured Settlement Trade Association is requesting the same correction. The ACLI fully supports their views that without clarification, injured parties who enter into settlement arrangements will be adversely affected.

Quite clearly the corporate holder of these deferred annuities does not share in or benefit from the income build-up on the annuities that are held for others. If Section 56(g)(4)(B)(iii) is not clarified, companies will revise their contracts so that the burden of the tax will fall on the beneficial owners of the annuity contracts, that is, on the employees or the injured parties.

The alternative minimum tax provisions are intended to include in the base for the tax economic income not included in the regular tax base. While somewhat ambiguous Section 56(g)(4)(B)(iii) appears to include the income attributable to contributions made to annuity contracts prior to March 1, 1986. That income is excluded from the coverage of Section 72(u). The income from the corporate-held annuities included in the exceptions under Section 72(u)(3) are excluded from the regular tax base. Since such income generally does not represent economic income to the corporate holder, it should also be excluded from the alternative minimum tax base.

GROUP-TERM LIFE INSURANCE PLANS -- EMPLOYEE CONTRIBUTION FORMULAS

Summary of Proposal: It should be made clear that the Section 89 non-discrimination testing rules, as added by the Tax Reform Act of 1986, accommodate both of the common contributory group-term life plan designs -- the "flat-rate" plan and the age, or "step-rate", plan.

Problem:

There are two very common group-term life contributory plan designs: (1) the age or "step" rated plan, where the rate of employee contributions is tied to age related premium brackets; and (2) the flat plan, where each employee pays the same amount per thousand dollars of coverage. These formulas have been in existence for many years, are widely used by employers, and were not in any way developed to deal with the peculiarities of non-discrimination testing for group-term life insurance. In this regard, it might be noted that the Federal Government's plan uses the flat contribution approach.

For reasons discussed in more detail below, each of these contribution approaches is consistent with long standing life insurance principles and neither should, in and of itself, cause a group-term life insurance plan to fail the non-discrimination tests. In order to assure that both approaches may pass the Section 89 non-discrimination requirements, it appears two aspects of the rules need to be clarified:

(1) Under the "step-rate" plan, employee contributions vary based on age. However, at each step, the employer is paying for the same percentage of each dollar of coverage. Thus, each separate contribution "step" should not be considered to give rise to a separate plan -- with arbitrary and potentially adverse consequences under the 50% eligibility test of Section 89(d)(1)(B) and its alternative, Section 89(d)(2).

(2) The "flat-rate" plan, by contrast, involves employee contributions that do not vary although the actual cost of the insurance protection increases with age. This plan design also should not be considered to give rise to a series of separate plans even though the employer contribution at each age level represents a different percentage of the actual cost of the coverage. If differing levels of employer provided benefit were assumed, a flat-rate plan could face severe testing problems under not only the 50% eligibility test but also the 90/50 test of Section 89(d)(1)(A) and the Section 89(e) benefits test as well.

Discussion:

Section 89 is designed to police benefit discrepancies that are based on compensation status. The two contributory plan formats described above are designed to deal with a factor that has nothing to do with high- vs. low-pay status -- that is, the increasing cost of life insurance at older ages. Both formats deal with this factor in accordance with traditional insurance principles.

In the flat plan an employee pays a level premium over the duration of his or her coverage rather than bearing an increasingly greater cost as that employee grows older. This follows the traditional individual whole life insurance model. The step-rate plan is more akin to the model of traditional individual term insurance where the individual's cost increases with age. Both designs represent an acceptable way to provide for the increasing cost of life insurance -- and both should be accommodated in the Section 89 testing scheme.

In order for Section 89 to accommodate both approaches to group-term life funding, two clarifications via technical correction may be needed:

1. A first step would be to clarify that a plan involving employee contributions that vary based on age will not, for that reason alone, be disqualified for treatment as a "single plan" for purposes of applying the Section 89 test.

2. A second step would be to clarify that the "employer provided benefit" provided under each of the two common contributory plans is to be measured in a manner that makes sense for that plan. Thus, in the "step-rate" plan, where employee contributions are based on actual cost, the portion of the total benefit that is "employer provided" should also be determined by looking at actual cost. In the "flat" plan, where employee contributions are based on an averaged, constant rate, the portion of the total benefit that is "employer provided" should similarly be determined by looking at an average, constant, cost -- for example, the Table I rate at age 40.

These clarifications would result in both formats for employee contributions being treated as a single plan. This would permit the two common contributory plan designs to be tested under Section 89 without distortions created by the chance dispersion of high and low compensated at various age levels.

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July 16, 1987

Bill Wilkins, Counsel
Committee on Finance
219 Dirksen Senate Office Building
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Dear Bill:

In response to your request for comments on the Technical Corrections Act of 1987, I am enclosing for the Committee's consideration a draft of a proposed technical amendment to Section 1201 (e) of the Tax Reform Act of 1986. This amendment addresses a problem that we have identified in the current high withholding tax transition rule that discourages debt-to-equity conversions of existing LDC loans.

From a Federal tax perspective, U.S. banks now find themselves in a difficult position in electing between a debt-equity conversion and full foreign tax credit utilization. Specifically, if a U.S. bank does nothing, interest on its existing debt has the benefit of the 1986 Act's transitional relief provision for high withholding tax interest. This specifies that interest on loans to 33 listed countries is includable in the financial service basket for 3 years and then phased out over the next five years.

A conversion of a qualifying loan from debt into an equity investment, however, results in the loss of this beneficial transitional rule and subjects the resulting income to the new separate baskets limitation rules. Upon conversion, a bank would be required to determine, on an investment-by-investment basis, which foreign tax credit basket to account for these equity investments. Under most circumstances, it will be difficult to qualify income from loan conversions as financial services income since the underlying income of the new equity investment will generally not be either passive income or income derived in the active conduct of a banking, financing, or similar business. Moreover, with most such equity conversions resulting in an interest in the investee company of between 10% and 50% with local entities holding the balance, the non-controlled Section 902 corporation basket is likely to apply.

Total local income taxes, plus withholding taxes on distributions, will usually cause the effective foreign tax rate on these investments to exceed significantly the U.S. tax rate. Therefore, the loss of transitional relief and the ability to average these excess credits with other financial services income, coupled with the harsh effect of the joint venture rules, can make debt-equity conversions unprofitable on an after-tax basis.

To cure this problem and to promote debt-equity conversions, it is recommended that a technical amendment be adopted to clarify that income received following a debt-equity conversion be situated in the same foreign tax credit category as the interest from the debt that was converted. (The proposed statutory language and a more detailed technical explanation are enclosed.) In recognition of revenue constraints, we have attempted to parallel the seven-year period of application for the high withholding tax interest transition rule and we propose that a taxpayer's principal amount of qualified loans entitled to transitional relief be reduced by the amount of any such loan conversion.

We strongly believe that the Federal tax laws should not inhibit debt-to-equity conversions. Such conversions are especially attractive for lesser developed countries as they provide one of the most viable means by which to reduce their indebtedness to U.S. lenders. Secondly, loan workouts, by means of conversions, historically have permitted lenders to recover on their original loan principal and, until payback is achieved, to secure an adequate rate of return. In fact, the Pre-1986 TRA Section 954-2(d) regulations expressly recognized this well-established banking practice.

We look forward to working with the Committee on this matter. American Express Bank Limited has been at the forefront of such conversions and has the technical staff available to respond to your inquiries.

Sincerely,

Denise Ferguson

Denise G. Ferguson

Amendments to Section 1201(e) of the Tax Reform Act of 1986

I. Sec. (2)(F) is amended by the addition of a new paragraph (iii):

(iii) The principal amount of qualified loans held by the taxpayer on November 16, 1985 shall be reduced by the principal amount of such loans which are the subject of a "debt-equity conversion."

II. Sec. (2) is further amended by the addition of a new paragraph (J):

(J) For purposes of this subsection the term "debt-equity conversion" means a transaction, pursuant to foreign law, whereby one or more qualified loans held by the taxpayer or an affiliate on November 16, 1985 are exchanged for, or otherwise converted into, stock in a foreign corporation. In the case of a debt-equity conversion involving debt not exceeding 110 percent of a qualified loan or loans so converted, dividends with respect to such stock and gains from the sale or exchange of such stock shall be treated for purposes of section 904 as interest, but not as high withholding tax interest. The preceding sentence shall cease to apply after the end of the sixth taxable year of the taxpayer following the year in which dividends are first paid by the foreign corporation and includible in the gross income of the taxpayer or an affiliate after the debt-equity conversion.

EXPLANATION OF AMENDMENTS TO SECTION 1201(e)
OF THE TAX REFORM ACT OF 1986

The proposed amendments are intended to encourage the conversion of certain developing country loans into stock interests in corporations doing business in those countries. Interest on such loans is, in general, subject to a foreign withholding tax. However, such interest is not (for a specified period and to a specified extent) high withholding tax interest by reason of transition rules that were adopted in section 1201(e) of the Tax Reform Act.

Conversion of such loans into stock is, under present law, disadvantageous because dividends and gains from the sale of stock do not qualify for the high withholding tax transition rules. Thus, as matters stand today, the rules regulating the foreign tax credit limitation actually discourage debt-equity conversions.

The proposed statutory amendments are intended to remedy that situation. As a technical matter, they are cast as amendments to the transition rules for high withholding tax interest and are intended to parallel those rules.

The first amendment provides that any qualified loan held by the taxpayer on November 16, 1985 which is the subject of a debt-equity conversion will reduce the "principal amount of qualified loans held by the taxpayer on November 16, 1985." This amount is a crucial component of the "applicable credit limit" used to compute high withholding tax interest transition relief. The amendment will prevent taxpayers from achieving a double benefit -- one in the special rule for debt-equity conversions (discussed below), and another in transition relief for the amount of the debt that is thus converted.

The second amendment is a special rule for income resulting from a debt-equity conversion. As noted above, this income will be in the form of dividends from stock and gains from the sale or exchange of stock. The special rule provides that such dividends and gains will be treated for purposes of the foreign tax credit limitation as interest, but not as high withholding tax interest. The rule will have the effect of situating income received following a debt-equity conversion in the same foreign tax credit category as interest from the debt that was converted.

Dividends and gains following a debt-equity conversion will be interest, under the special rule, only for purposes of the foreign tax credit limitation. Thus, dividends with respect to stock received as a result of a debt-equity conversion, and gains from the sale or exchange of such stock, will be eligible for the deemed paid foreign tax credit under section 902, 960, or 1248. However, for purposes of section 904, all such income will be treated as interest.

For taxpayers who are predominantly engaged in a banking, financing, or similar business, such interest will be financial services income. For other taxpayers, the interest will be passive income.

The special rule for debt-equity conversions will apply regardless of whether the stock interest in the foreign corporation is a majority interest and regardless of whether the entity that holds the stock interest is the original lender or an affiliate. That is, the benefits of the rule will not be affected by the section 904 rules relating to noncontrolled section 902 corporations and to the "look-through" rules applicable to controlled foreign corporations. It is expected that debt-equity conversions will generally result in minority stock interests, over time if not initially. Furthermore, it is anticipated that, in certain cases, the foreign tax cost of a stock investment can be reduced by holding the interest in a foreign corporation.

The benefits of the rule will be geared roughly to the seven-year period of application of the high withholding tax interest transition rules. However, in light of the fact that a taxpayer's return following a debt-equity conversion may require a lengthy pay-out period, the seven-year transition period is proposed to begin only as of the first year in which the investment begins to pay dividends to the taxpayer or an affiliate after the conversion.

Finally, the special rule for debt-equity conversions applies not only to loans held on November 16, 1985 but to an amount of up to 10 percent of other loans as well. The purpose of the rule is to encourage conversions, and a narrow limitation to debt held on November 16, 1985 could unnecessarily frustrate that purpose.

American Farm Bureau Federation

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July 23, 1987

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D. C. 20210

Dear Senator Bentsen:

In response to the Committee's request for comments on S. 1350, the Technical Corrections Act of 1987, Farm Bureau appreciates the opportunity to discuss two issues which are raised with regard to the technical corrections package. While these points do not relate directly to the provisions of the bill, they do relate to the Tax Reform Act of 1986. We believe that they warrant the Committee's examination, particularly since there may be no other appropriate forum for their consideration in this session of Congress.

PREPRODUCTIVE PERIOD EXPENSING

The Tax Reform Act of 1986 made a major change in the way expenses are recovered for producers who raise replacement stock for their livestock herds. Under the old law, producers could expense the costs of raising such livestock in the year the expenses were incurred. The new law requires that these expenses be capitalized if the preproductive period is two years or longer. An election can be made to use expensing, but all assets used in the farming operation must use straight line depreciation rather than more favorable depreciation methods and expensed costs must be recaptured upon disposition of the animal.

We believe that the new capitalization and election provisions are unworkable. The record keeping associated with allocation of the expenses of raised livestock are unwieldy as producers attempt to separate the costs of raising livestock (some of which will be replacement animals) from the allocation of expenses for other animals which will not be placed in the herd.

Another major question for which no answer seems to exist is the length of the preproductive period. How is it determined? From conception until a heifer is placed in the breeding herd? From the birth of the animal until placement in the breeding herd? In addition, we question whether the recapture associated with the expensing election is necessary particularly since capital gains treatment is no longer permitted.

The Honorable Lloyd Bentsen
July 23, 1987
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We call your attention to S. 1353, introduced by Senator Kasten (R-WI) and Senator Quayle (R-IN), which would repeal the requirement that farmers capitalize the expense of raising their livestock. This legislation is supported by Farm Bureau policy and we urge the Committee to consider it during the mark up of the technical corrections package.

DEDUCTIBILITY OF HEALTH INSURANCE COSTS OF THE SELF-EMPLOYED

The Tax Reform Act of 1986 allows a 25 percent deduction for health insurance premiums of self-employed taxpayers between 1987-89. The deduction will be allowed only if the coverage is provided under one or more plans meeting the new fringe benefit nondiscrimination rules. As a result, it appears that employees will have to be covered under an employer-provided health insurance plan.

As written, this provision causes problems because it is doubtful that many self-employed taxpayers, especially farmers, furnish health insurance to their employees. The cost of such employee benefit plans is prohibitive to many farmers, particularly since many farmers themselves do not carry health insurance because of extremely high premiums.

In fact, we have reservations about the move in Congress to mandate certain employee benefits. The costs of these programs could push even more farmers over the brink by increasing costs associated with farm labor.

While the dialogue of mandated benefits will be lengthy, we urge the Committee to look specifically at this time at the health insurance deduction for self-employed taxpayers and to remove the restrictions that will discourage its use by self-employed farmers and ranchers. We remind the Committee that the provision, which originated as a 50 percent deduction with no time limit, was watered down significantly in conference to 25 percent over a three-year period. In fact, Farm Bureau supports a deduction for the full cost of health insurance premiums as a business expense.

We appreciate the Committee's consideration of our comments about the need for annual expensing of preproduction period costs rather than capitalization, and a workable and expanded deduction for the health insurance costs of self-employed taxpayers. We would be pleased to provide you with other information should you desire it.

Sincerely,

John Datt

John C. Datt
Executive Director
Washington Office

JCD/lh

Statement of Herbert J. Lerner

on Behalf of the

American Institute of Certified Public Accountants

Introduction

Mr. Chairman and Members of the Subcommittee, I am Herbert J. Lerner, Chairman of the Federal Taxation Executive Committee, testifying today on behalf of the American Institute of Certified Public Accountants and its nearly 250,000 CPA members. Joining me today is Donald H. Skadden, AICPA Vice President - Taxation. We appreciate the opportunity to present our views on an issue of concern to tax practitioners and small businesses throughout the country.

Mr. Chairman, we are here today to discuss legislation you and your colleague, Senator Heinz, have introduced which, if enacted, would remedy many of the problems and complications created by Section 806 of the Tax Reform Act of 1986. Section 806 mandated that most partnerships, S corporations, and personal service corporations conform their tax years to the tax years of their owners. Section 806 was enacted to address a perceived problem of tax deferral arising from non-conforming years and to raise additional revenues. It will impose a significant burden on small business, on the accounting profession, and on the IRS.

Mr. Skadden and I, along with other members of the AICPA, appreciate the opportunity we have had to work closely with your staff, as well as the staff of the Joint Committee on Taxation, in developing a solution to the problems created by Section 806. We are grateful to you, Mr. Chairman, to Senator Heinz, and to your staffs for the significant effort put forth and for your leadership in supporting a viable solution to this real and serious problem.

Consistent with the political and economic realities at this time, this proposed legislation has been crafted to derive essentially the same amount of revenue from the same group of taxpayers as under the Tax Reform Act of 1986. However, it does so by addressing the issue of tax deferral and tax payments in a unique manner which avoids the administrative problems of shifting most affected taxpayers to the same calendar year end.

A companion bill has been introduced in the House of Representatives by Congressman Ronnie Flippo, who is a CPA and a member of the House Ways and Means Committee. Since the proposal is essentially revenue neutral in relation to the Tax Reform Act of 1986, we suggest that this legislation could appropriately be included in the Technical Correction Act of 1987 (S. 1350 and H.R. 2636).

Let me state at the outset, from a tax policy standpoint, that your legislation was not the AICPA's desired solution to the problem. We would have preferred outright repeal of the year end conformity requirement. However, given the need for a revenue neutral alternative and the belief that tax deferral was a serious problem which should be addressed, in our opinion your legislation is the most viable alternative to the year end conformity requirement.

History of the Year End Conformity Requirement

First, I would like to present some background on the year end conformity requirement and explain how Section 806 became part of the Tax Reform Act of 1986 (H.R. 3838).

The year end conformity requirement was not part of the Treasury Department proposal released in December 1984; it was not part of the President's proposal released in May 1985; and it was not part of H.R. 3838 as passed by the House of Representatives in December 1985. During 1985, the Senate Finance and House Ways and Means Committees held 36 days of hearings on tax reform, and at no time was this provision discussed. A less stringent version of the tax year requirement was added to the Senate Finance Committee package. This Finance Committee version would have continued to allow fiscal years ending in September, October, or November.

An amendment was added on the floor of the Senate during the final hours of debate on tax reform which compounded the problem by mandating the December 31st year end for most partnerships, S corporations, and PSCs.[1] We believe that members of the Senate did not fully understand the many problems this requirement would cause for small business owners, for CPAs, and for the IRS. Section 806 was advanced to keep the Tax Reform Act of 1986 revenue neutral, rather than for sound tax policy reasons.

Impact of the Year End Conformity Requirement on Small Business, the Accounting Profession, and Administration of the Tax System

In the past, sound tax policy permitted the use of fiscal tax years which resulted in staggered tax return filing dates to allow the IRS, taxpayers, and tax practitioners to better meet tax filing requirements. The Tax Reform Act of 1986 failed to recognize that there are many legitimate business reasons for selecting a fiscal year. Fiscal years are ordinarily chosen to coincide with the "natural business year" of an entity, and as a consequence Section 806 will cause tax requirements to interfere with business operations.

Section 806 will place an undue burden on the tax system. Taxpayers and return preparers will have difficulty completing the returns of affected entities in sufficient time to allow partners and shareholders to file their individual tax returns by the original due date. This will necessitate costly and inconvenient extensions of time to file returns. Further, it will be difficult to obtain the information necessary to estimate the tax liability of owners in order to apply for an extension without undue risk of penalties. Encouraging the extended filing of tax returns is inconsistent with the efficient operation of our self-assessment system.

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[1] As a practical matter, a fiscal year conformity requirement affects most partnerships, S corporations and PSCs with tax years other than the calendar year, since most of the owners of these closely-held entities are individuals on the calendar tax year.

Section 806 will impose other costs and administrative burdens on small businesses. Affected entities would be required to close their books twice and file two sets of tax returns (both federal and state) in calendar year 1987 in order to change their tax years. Because Section 806 applies to existing as well as newly formed entities, businesses which have used a fiscal year for many years will now have to amend contracts, compensation arrangements, and retirement and employee benefit plans as a result of this provision.

Section 806 will also create significant workload problems for CPA firms which will be required to compress tax return preparation, financial reporting, and auditing work into a shortened time period. A survey of AICPA Tax Division members revealed that more than 60 percent of their annual workload will now fall in a three-and-a-half month period as a result of the year end requirement. Even if the extension requirements are liberalized, not enough of this work could be spread throughout the year since the accounting and financial reporting needs can not, as a practical matter, be extended much beyond the close of the reporting year.

A further concern is the possibility that, Sections 441 and 442 of the Internal Revenue Code may be interpreted by the IRS to require the financial statement year end to conform to the tax year end for entities subject to Section 806. We understand that the IRS has under consideration the possibility that the financial statement conformity requirement for voluntary year end changes would also apply to mandatory year end changes.

In summary, this requirement of the Tax Reform Act of 1986 will place administrative and financial hardships on small businesses and CPA firms.

AICPA Endorses Baucus-Heinz Legislative Proposal

The AICPA strongly supports your legislative proposal, Mr. Chairman, as it would resolve the fiscal year issue -- on an essentially revenue neutral basis -- without mandating changes in the tax reporting periods of partnerships, S corporations, and PSCs. We suggest that your legislation be incorporated into the Technical Corrections Act of 1987, with an effective date of January 1, 1987.

Your legislation would allow entities which are affected by Section 806 to elect to retain their fiscal years. This optional election would be made at the entity level, not by the individual owners.

Under the provisions of your legislation, owners of electing partnerships and S corporations would be required to make enhanced estimated tax payments determined with reference to the amount of tax deferral based on the entity's preceding fiscal year return. Thus, affected entities could retain the fiscal year that suits their business needs, while making enhanced estimated tax payments in lieu of actual tax payments.

Owners would be required to increase either of the two estimated tax payment safe-harbors (100 percent of prior year's tax or 90 percent of current year's tax) by a percentage of the prior year's deferred income based on the length of the deferral period. The enhanced estimated tax would be calculated at a rate of 35 percent for 1987 and at the highest individual marginal rate in the following years. There is a four-year phase-in of the enhanced estimated tax payments which corresponds to the four-year income spread in the Tax Reform Act of 1986.

For personal service corporations your legislation would postpone the corporate level deduction for salary and other payments to owners if ratable payments have not been made prior to December 31. The safe-harbors for determining whether a deduction is allowed would be based on experience from the prior corporate year, in order to avoid the necessity of predicting income, or actual payments made for the remainder of the current year.

Any entity which is subject to Section 806, and which newly elects or changes its fiscal year, must select a year ending no earlier than September 30. Included in this option are C corporations which elected S corporation status and as a consequence were required to change to a calendar year.

Your legislation also provides a de minimis exclusion whereby taxpayers with aggregate enhanced estimated tax of $200 or less with respect to electing partnerships and S corporations are exempt from this requirement.

It is recognized that retention of fiscal years could create an abusive situation where tiered ownership structures are used. To avoid this, your legislation provides that a partnership, S corporation, or PSC which receives a major part of its gross income from a partnership or S corporation and which has a different tax year from the related entity, is not allowed to retain its fiscal year. This prohibition is not intended to apply to nonabusive situations, such as where the entity has an equity interest in another entity which is not substantial in relation to the owning entity's entire activity.

Your legislation does not provide a tax solution to certain tiered structure situations, such as where a fiscal year PSC owns an interest in a calendar year partnership corresponding to the interest previously owned by the PSC's sole stockholder who is an individual on a calendar tax year. Although we have not developed a solution to this problem, we would support any reasonable proposal which is essentially revenue neutral based on the tax liabilities of the affected class of taxpayers.

It is important to remember that those entities which would be allowed to remain on or to adopt a natural business year under the Tax Reform Act of 1986, could still do so without being subject to the requirements of this legislation. Thus, an entity which is otherwise entitled to use a fiscal year based on a business purpose which satisfies IRS established criteria (including those reflected in Revenue Procedure 87-32 and Revenue Ruling 87-57) will be able to do so without being subject to the requirements of this legislation.

Conclusion

We strongly support your solution to the problems resulting from the year end conformity requirement of the Tax Reform Act of 1986. The AICPA believes it offers an alternative, for those entities which wish to elect it, that is both responsible and effective, and that it merits careful consideration by your Committee. We stand ready to continue to work with you and your staff in the enactment of this much needed correction to the Tax Reform Act of 1986.

Mr. Chairman, this concludes our statement. We will now gladly answer any questions that you or Members of the Subcommittee may have.

STATEMENT OF RICHARD MERSKI
AMERICAN INTERNATIONAL GROUP, INC.
on
S.1350, the Technical Corrections Act of 1987
before
The Senate Finance Committee
Subcommittee on Taxation and Debt Management
July 22, 1987

Mr. Chairman and members of the Committee, my name is Richard Merski. I am the Director of Government Affairs of the Washington office of American International Group, Inc. ("AIG"), which through its subsidiaries is primarily engaged in a broad range of insurance and insurance-related activities in the United States and abroad. AIG appreciates the opportunity to present its views on proposed corrections to the Tax Reform Act of 1986 (the "Reform Act") being made by S.1350, the Technical Corrections Act of 1987. In particular, I wish to focus on a matter which, though technical in nature, is of great importance to AIG -- the treatment of investment income attributable to insurance of risks within the same country of incorporation of a controlled foreign corporation ("CFC").

Current Law

The Reform Act expanded the definition of Subpart F income by defining "insurance income" under Section 953(a) to include any income derived from the insurance or reinsurance of risks in connection with property located in, liability arising out of activity in, or in connection with the lives or health of residents of a country other than the country in which the CFC is incorporated. The Reform Act was intended to apply to insurance income earned on CFC insurance risks outside the country in which the corporation is organized. AIG does not believe it was Congress' intent to apply to underwriting and investment income attributable to insurance of risks within the same country in which the corporation is incorporated or where it is conducting an active business in such fashion so that the income cannot be manipulated from a high tax jurisdiction to a low tax jurisdiction. This interpretation is consistent with the statement in the House report that investment income taken into account under Section 953 of the Code is not treated as foreign personal holding company income under Section 954 of the Code:

> "Second, income of any kind received by an offshore insurance company, including income derived from its investments of funds, will generally be subject to taxation under Section 953, as described below. Regulations under present law specify that taxation of an insurance company's income under Section 953 takes precedence over its treatment as foreign personal holding company income. Thus, dividends, interest, and gains derived by a controlled foreign insurance company will not generally be treated as foreign personal holding company income in any event, if they are instead taken into account under Section 953." H.R. Rep. No. 99-426, 99th Cong. 1st Sess. at p. 399 (December 7, 1985).

Issues

The removal of the exclusion previously contained in Section 954(c)(2) of the pre-Reform Act Code to Subpart F for investment income derived from the necessary reserves of an insurance company or its necessary surplus is inconsistent with the retention of the same country exception for insurance income as provided in Section 953 and inconsistent with the long established concept in the Code that investment income generated on insurance reserves, unearned premiums, and necessary surplus should be considered insurance income. For example, investment income attributable to insurance of related party risks is subject to the new Subpart F provisions relating to captive insurance companies. Deductions for reserves allowed under Subchapter L are also adjusted under the Reform Act to reflect in part the time value of money and tax exempt interest on investments of reserves. The Tax Reform Act of 1984 also required that the source of insurance income (underwriting and investment income) derived by a CFC from insurance of U.S. risks be determined by reference to the risks insured.

The absence of an explicit exclusion for investment income attributable to insurance of risks within the country of incorporation is also inconsistent with the general treatment of non-financial companies. The whole concept of Subpart F income and the term "foreign base company" reflects the concept that United States shareholders should be taxed only on income which is passive in nature or income diverted from a related person in one jurisdiction to a CFC organized in a different foreign country. This is clearly reflected in the definitions of the various items which constitute foreign base company income and the specific exclusions for income from the same country of incorporation. Congress has never consciously extended the scope of Subpart F to include income derived from the active conduct of a trade or business in the same country in which the CFC which earns it is organized, in part because extension of that principle would force U.S. controlled business to bear higher rates of tax than foreign competitors.

In the absence of a technical amendment to the Reform Act a CFC which is an insurance company will be subject to significant overtaxation on its true taxable income because its taxable foreign personal holding company income will not take account of the deductions which would otherwise be allowed against underwriting and investment income if it were a domestic corporation. This can best be understood in the case of a controlled foreign life insurance company, where practically all of such a company's "taxable income" under Subpart F is attributable to the investment income which will be returned to policyholders. A domestic life insurance company is allowed a current deduction against all of its gross income under Section 805(a) of the Code for the net increase in its reserves, policyholder dividends, and other specified amounts, but no such deduction would reduce foreign personal holding company income under Subpart F. Under Section 954(b)(5) of the Code, foreign personal holding company income and other foreign base company income are reduced, under regulations, by deductions properly allocable to such income. Under current Treasury regulations, however, deductions allowed to a controlled foreign life insurance company reduce "gain from operations", i.e., underwriting income taken into account under Section 953, and not foreign personal holding company income. Treas. Reg. § 1.954-1(c), § 1.952-2(b)(2) and § 1.953-4.

Recommendation

The Technical Corrections Act should amend Section 954(c) of the Code to exclude from the definition of a foreign personal holding income, income derived by an insurance company from the investment of:

(i) unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business,

(ii) an amount of its assets equal to one-third of its premiums earned on insurance contracts (other than life insurance and annuity contracts), and

(iii) in the case of a life insurance company, an allocable portion of surplus determined under principles analogous to those under Section 813 of the Code, in each case attributable to the insurance (or reinsurance) of risks arising in the country in which the insurer (or reinsurer) is organized.

For purposes of (i), (ii), (iii), and Section 953(a), a branch of a foreign corporation licensed and predominantly engaged in the insurance business in a foreign country shall be treated as a separate foreign corporation created under the laws of the country in which the branch is licensed.

Explanation

The exclusion allowed by the proposed amendment would be available only to an "insurance company", i.e., a corporation which would be taxable under Subchapter L if it were a domestic corporation. This will require that the corporation's primary and predominant business activity during the taxable year be the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Treas. Reg. § 1.801-3. Amounts not excluded would be subject to tax under Section 953 or other provisions of Section 954.

The amount of the exclusion under the proposed amendment can be objectively determined by a limiting mathematical calculation which is a function of the premiums produced and retained by the CFC if principles analogous to those in Treas. Reg. § 1.954-2(d)(3) are applied. Thus, unlike the situation of CFCs engaged in the conduct of the banking business which lost deferral on interest income in the Reform Act, there would be a strict and objective determination made.

Branches would also be treated as separate corporations under the proposed amendment for purposes of determining Subpart F insurance income consistent with Section 954(d)(3) of the Code, which now treats such a branch as a wholly owned subsidiary corporation for purposes of determining its foreign base company sales income. Such treatment is also consistent with the rules provided in Section 814 of the Code and its predecessors relating to U.S. life insurance companies operating in Canada or Mexico in branch form.*

* For background information, see S.Rep. No. 94-938 (Part 1), 94th Cong. 2d Sess. at pp. 271-5 (1976), reproduced in 1976-3 C.B. (Vol. 3) at pp. 309-13.

COMMENTS OF
AMERICAN LAND TITLE ASSOCIATION
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
REGARDING
TECHNICAL CORRECTIONS ACT OF 1987

July 24, 1987

Description of Section 115(e)(2)

1. Section 115(e)(2) of S. 1350 would add new paragraph (3) to section 6045(e) of the Internal Revenue Code of 1986.

2. Section 115(e)(2) would prohibit the settlement agent from separately stating to any customer the cost of reporting the transaction.

Arguments Supporting the Deletion of Section 115(e)(2)

1. The provision is not a technical correction but a substantive change in the law. Therefore, it is not appropriate to include it in technical correction legislation.

2. Section 115(e)(2) was introduced before Congress had the opportunity to observe information reporting on real estate transactions. The ALTA believes that, at the very least, the cost data should be available before a provision is enacted regulating how settlement agents may treat these amounts.

3. Settlement agents should not be regulated with respect to how they may advertise or price their services. The business of closing real estate transactions is highly competitive and the market will force settlement agents to charge reasonable rates.

4. Settlement agents should not be singled-out for this type of treatment. No other industry is regulated in this manner. Settlement agents have a unique one-time relationship with their customers. Other reporters may recover reporting costs over a number of transactions. Settlement agents must recover these costs, if at all, in one transaction.

5. The Real Estate Settlement Procedures Act (RESPA) requires the settlement agent to itemize the costs associated with closing if the settlement involves a Federal related mortgage loan. Section 115(e)(2) would require the agent to hide a cost from the customer.

The American Land Title Association (ALTA) wishes to thank the Committee on Finance for the invitation to comment on S. 1350, the Technical Corrections Act of 1987. The ALTA takes this opportunity to respectfully request that section 115(e)(2) be deleted from S. 1350. This statement is submitted to the Committee on Finance by the ALTA on behalf of our members.

A. Description of the Association

The ALTA, founded in 1907, is the trade association representing 2,300 abstracters and agents, title insurance companies and associated members. The ALTA members directly employ more than 100,000 people and engage thousands of independent attorneys as agents. The ALTA was organized to promote the safe and efficient transfer of ownership of real property. To this end, the ALTA endeavors to provide information and education to consumers and to those who regulate, supervise or enact legislation affecting the land title industry.

B. Description of Section 115(e)(2)

Section 115(e)(2) of S. 1350 would add new paragraph (3) to section 6045(e) of the Internal Revenue Code of 1986. The Tax Reform Act of 1986 amended section 6045 to require a "real estate broker" to file information returns with respect to certain transactions in real estate. In most cases, the person responsible for reporting the transaction is the settlement agent. Section 115(e)(2) would prohibit the settlement agent from separately stating to any customer the cost of reporting the transaction. The ALTA believes that this provision is not appropriate for technical corrections legislation because it represents a substantive change in the law. We further believe that legislation of this nature is premature, represents unnecessary and inequitable regulation of the real estate settlement industry and is contrary to sound tax policy.

C. Arguments Supporting the Deletion of Section 115(e)(2)

Section 115(e)(2) is not a technical correction but a substantive change in the law. The scope of the Technical Corrections Act should be limited to fine-tuning new provisions and correcting mistakes that were made in the Tax Reform Act of 1986. Section 115(e)(2) is much more than a minor adjustment. There are considerable policy implications associated with using the tax code to regulate how an industry may price and advertise its product. This alone should suggest that S. 1350 is not the proper legislative vehicle for this provision. Legislation of this nature should be the topic of extensive public comment and debate. It should not be included in a technical corrections bill.

Section 115(e)(2) was introduced before Congress had the opportunity to observe information reporting on real estate transactions in practice. Real estate reporting had been required for only one month at the time S. 1350 was introduced.[1] Settlement agents have not had the chance to determine what the additional cost will be, much less whether the cost should be absorbed by the agent or passed on to the seller. Our members anticipate that the bulk of the cost of information reporting will be incurred during the initial years. New computer equipment will have to be purchased and systems to accommodate reporting must be designed. The cost of reporting should taper off significantly after the initial investment is made. Our members believe that, at the very least, the cost data should be available before a provision is enacted regulating how the settlement agents may treat these amounts.

Even after the necessary cost data becomes available, settlement agents should not be regulated as to how they may advertise or price their services. The business of closing real estate transactions is a highly competitive one. The ALTA alone represents thousands of settlement agents, all competing with each other for business. Settlement agents are not in position to force consumers to pay additional costs. The free market will inevitably shake-out any agents attempting to gouge the consumer with excessive fees.

Like any other business confronted with the additional cost of information reporting to the IRS, settlement agents must decide whether to absorb the cost or pass it on to the customer. Section 115(e)(2) would treat settlement agents unfairly in this respect. No other information reporter is restricted with respect to how such costs are handled. Most information reporters have an ongoing relationship with their customers. Thus, they are able to recover the cost of information reporting over time in small increments. Settlement agents, on the otherhand, are unique in that they have a one-time relationship with their customers. Costs that are not recovered up front will never be recovered. By interfering with their ability to recover these costs, section 115(e)(2) places settlement agents at a disadvantage with respect to other information reporters.

A real estate closing can be a very confusing event for the typical buyer or seller. Without adequate disclosure it would be very difficult to keep track of all the closing costs. To relieve some of this confusion, the Real Estate Settlement Procedures Act (RESPA) requires settlement agents conducting settlements involving any Federal related mortgage loan to prepare a HUD-1 Settlement Statement. The HUD-1 itemizes the costs associated with the closing and discloses how the costs are allocated between the buyer and the seller. In this manner, the parties to a transaction know exactly what the costs are and who is responsible for them. This policy of disclosure promotes understanding of the closing process and enhances the credibility of the real estate industry. However, section 115(e)(2) runs completely contrary to this policy. It would, in effect, require the agent to withhold certain cost information from the customer. It is not good tax policy to enact a provision that requires a taxpayer to conceal price information from its customer.

The ALTA believes that its members should be allowed to price their services (and communicate those prices to the customer) in a manner that is free from government regulation. Furthermore, buyers and sellers of real estate have a right to know exactly what they are paying for. We, therefore, urge the Committee to delete section 115(e)(2) from the S. 1350.

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[1]Real estate information reporting technically is required for transactions closed after December 31, 1986. However, Temporary Treasury Regulation Section 1.6045-3T(p) provides that no penalty will be imposed with respect to a transaction closed before May 4, 1987. The TCB was introduced on June 10, 1987.

American Leprosy Missions
One Broadway, Elmwood Park, New Jersey 07407 (201) 794-8650

John R. Sams, President
William R. Davies, Vice President
Dr. Felton Ross, Medical Director
Robert M. Bradburn, Director of Development

June 26, 1987

Laura Wilcox
U. S. Senate Committee on Finance SD.
Washington, DC 20510

To the Members of the Senate Finance Committee:

We in charitable organizations depend upon charitable lead trusts to help raise funds for the various projects that we are involved in. When a consideration by the Senate Finance Committee to appeal the charitable deduction as an offset against a generation-skipping tax on charitable lead trust, donors instead of continuing to give hold back their gifts. If we cannot continue to count upon the charitable gifts of Americans than either one, we would need to call upon government to make it a part of our taxes or two, aberrant our responsibilities in the privileges that God has given us and let those who are unable to help themselves suffer even more.

Therefore I urge you to reconsider the repeal of the charitable deduction as an offset against the generation-skipping tax on charitable lead trust.

Thank you.

Sincerely,

Richard R. Hamilton, Jr.
Vice President of Development

RRH:fh

STATEMENT OF THE

AMERICAN PETROLEUM INSTITUTE

REGARDING

THE TECHNICAL CORRECTIONS ACT OF 1987
H.R. 2636

The American Petroleum Institute is a trade association representing all segments of the petroleum industry. In anticipation of technical corrections to the 1986 Tax Reform Act, API recommended that section 263A of the Code, added by section 803 of the 1986 TRA, be amended to exclude foreign intangible drilling costs (IDCs) described in section 263(i) of the Code and amounts described in section 291(b) of the Code from the uniform capitalization rules. IDCs described in section 263(c) are excepted from the capitalization rules by section 263A(c)(3).

Section 108(b) of the Technical Corrections Act adds section 291(b) to the list of costs excepted under section 263A(c), but fails to address section 263(i) foreign IDCs. Apparently, the omission of 263(i) was inadvertant. It is recommended that 263A(c)(3) be amended to specifically except IDCs described in section 263(i).

STATEMENT BY HELEN MARCUS, PRESIDENT OF THE
AMERICAN SOCIETY OF MAGAZINE PHOTOGRAPHERS
ON THE
TECHNICAL CORRECTIONS ACT OF 1987
(H.R. 2636 AND S. 1350)
July 31, 1987

Helen Marcus, President of the American Society of Magazine Photographers (ASMP), respectfully submits the following statement concerning the Technical Corrections Act of 1987 for consideration by the U.S. House of Representatives Ways and Means Committee and the U.S. Senate Finance Committee. Founded in 1944, ASMP is the leading voice of the photography industry in the United States and abroad. In addition to the national office located in New York City, there are 29 local chapters throughout the country. Its membership consists of over 5,000 professional photographers. The members work in every area from advertising and industrial/corporate to documentary and photo journalism - in print, tape, and related visual media.

ASMP is an organization of individuals. ASMP Vice President Michel Heron, in a July 13, 1987 article in The Wall Street Journal concerning federal tax law, described a typical professional photographer as "the smallest of the small businesses." Very few professional free-lance photographers have available to them the special legal and accounting tax services which would be necessary to comply with complicated accounting and recordkeeping procedures. With that in mind, it is easy to understand the concern and confusion which ASMP members felt when confronted with the 1985 Internal Revenue Service contemporaneous recordkeeping requirements for their equipment.

It is that same sense of confusion and concern which the ASMP membership felt as it considered the possible consequences of a footnote in the Conference Committee Report in the Tax Reform Act of 1986. The footnote is contained in Title VIII, Section D, page II-308.

The House and Senate conferees had agreed to limit the application of Section 263A uniform capitalization rules to tangible property, thereby excluding intangible property. A footnote was inserted, however, which said that for the purposes of Section 263A, "tangible property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creators thereof." The footnote was recently referred to in a case decided on May 19, 1987, by the United States Court of Appeals for the Second Circuit, Hadley and Bryant v. Commissioner of Internal Revenue and Garrison v. Commissioner of Internal Revenue, Docket Nos. 86-4148, 4153. In that case, Judge Oakes speculated in dictum that authors of books are now required to follow the uniform capitalization rules. There is great uncertainty among professional photographers as to the effect of the footnote and whether they come within its reach.

ASMP would argue that current expensing of the costs of creating photographs is entirely consistent with the cash method of accounting traditionally permitted for free-lance creators of all kinds. A photographer may shoot thousands of images on a project and perhaps only two or three (or none) will generate any income. When would the appropriate time be to write off a product when it appears it will never sell? Consider also that some images may not generate income for decades, perhaps not even until after the death of the photographer. Since the income stream is difficult, if not impossible, to predict current expensing is the most appropriate method of accounting in the case of photographers.

Furthermore, ASMP believes that the costs which would be required of its members to comply with uniform capitalization rules would be entirely inconsistent with the revenue which can be expected from this provision. The additional costs and lost productivity, with the inevitable reduction in taxable income, would more than offset any expected revenue gains resulting from the capitalization requirements.

Serious ambiguity arises when one considers the previously mentioned footnote. The footnote says that tangible property which must be capitalized includes "films..... and other similar property embodying.... images." Does that refer to the magazine in which the photograph is published, or is it the photograph itself? In Hadley, Judge Oakes ruled that the word "production" in the now-repealed Section 280 was descriptive of what is done by the publisher of the book, not by the author of the manuscript. ASMP would argue it is the producer of the book, the magazine, the advertisement, or any other work embodying the photograph, not the photographer, who was likewise covered by Section 280.

By the same token, the word "produced" in Section 263A is no more descriptive of what a photographer engages in than the word "production" was in Section 280.

Professional photographers pay taxes on their income as they receive it. They are not entities formed for tax shelter purposes. They are individual artists, technicians, and entrepreneurs who contribute to the creative spirit of American society. Just as Congress saw fit to relieve these men and women of the contemporaneous record keeping requirements in 1985, it should remove any confusion regarding Section 263A and expressly exclude photographs, images and similar property from the definition of tangible property. One way to achieve that result and remain consistent with other provisions of the Internal Revenue Code would be to exempt from Section 263A(b) property defined in Section 1221(3). Capitalization rules apply to capital assets, items with a useful life beyond the year in which they are produced. Section 1221(3) expressly states that the term "capital asset":

"does not include a copyright, a literary, musical or artistic composition, a letter or memorandum, or similar property, held by - (A) a taxpayer whose personal efforts created such property, (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B)."

ASMP respectfully suggests that an amendment to the Technical Corrections Act of 1987 which would exempt property defined in Section 1221(3) from coverage under Section 263A would clarify the confusion surrounding this issue. It would provide a consistency between Sections 1221(3) and 263A. Such an amendment would also further Congress' tax reform goals of simplifying the tax code and improving taxpayer compliance.

For all of the foregoing reasons, ASMP urges adoption of the corrections described above. ASMP appreciates this opportunity to convey its views regarding Section 263A, and to submit its testimony at this time.

AMERICAN SOCIETY OF PENSION ACTUARIES

Howard Phillips, Chairman
Government Affairs Committee
60 Route 46 East
Fairfield, New Jersey 07007
(201) 575-1100

July 23, 1987

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate
205 Dirksen Building
Washington, D. C. 20510

Dear Senator Bentsen:

The American Society of Pension Actuaries represents more than 2,000 actuaries and consultants who represent clients who sponsor a significant percentage of the private retirement plans in the United States. ASPA is pleased to provide you with comments you seek on S.1350, the Technical Corrections Act of 1987. Our comments will include technical corrections which are needed to the Technical Corrections Bill, and will include our suggestions for items needing clarification or change in connection with the retirement provisions of the Tax Reform Act of 1986. These suggestions involve areas which we believe were overlooked in preparing the retirement plan portion of the Technical Corrections Act of 1987, and should be addressed if the pension community is to understand how to operate under the Tax Reform Act of 1986.

I have separated the lists into two parts. One member of ASPA is responsible for each part, and will be available to you if further discussion is needed on any one of the items in either of the parts. The contact for Part I is:

Mr. Edward E. Burrows
PENTAD
360 Bear Hill Road
Waltham, Massachusetts 02154

(617) 890-1780

The contact for Part II is:

Mrs. Marjorie Martin
Noble Lowndes Becker
33 Evergreen Place
East Orange, New Jersey 07018

(201) 675-8900

ASPA is pleased to have this opportunity to provide these comments and suggestions to you. If I can assist you in any other way in this regard, please contact me.

Sincerely,

Howard M. Phillips, F.S.A., M.S.P.A.
Chairman

HMP:akm
Enc.

PROPOSED CHANGES IN TECHNICAL CORRECTIONS BILL

PART I

SEC. 111(c)

- This first item refers to adjustments of refunded excess deferrals, excess contributions and excess aggregate contributions to reflect investment results. Apparently, the intent is to require adjustments which reflect the period between the end of the year of reference and the date of distribution.

  If this approach must be taken, it seems urgent that a rough justice method be mandated. One such method would be to determine investment results for the year of reference and then extrapolate these results to the date of distribution. It would have to be provided that the method will not serve to reduce the account balance below zero.

- Clarify that unless a contribution which matches a refunded excess contribution is removed, the result violates 401(a)(4).

SEC. 111(d)

- Delete the proposed provision precluding the actuary from anticipating inflationary changes in the $200,000 limitation.

- Provide that a contribution which is necessary under 412 but non-deductible because of 404(a)(8) is exempt from the non-deductible contribution excise tax of 4972.

- Incorporate a similar provision exempting a contribution which is required under 412 but not currently deductible because of 263A.

- This next item involves the process of measuring years of participation for purposes of 415(b)(5) and 415(e). There has been great consternation and uncertainty over this issue.

  Current thinking seems to be that participation in a DC prior to participation in a DB will not count either for 415(b) or for 415(e).

  Current thinking seems to be that participation in a DC following participation in a DB will count for 415(e). However, years of DC participation will be factored in year by year. In contrasts, where the individual remains a participant in a non-terminated DB, it is permissible to project future participation.

  We are all coming to the realization that nobody had ever given adequate thought to the question of projecting service after service had terminated. However, it appears to have been conventional practice not to change the DB fraction merely because service had terminated. The analogue, now that participation is what counts, is that the fraction should not be changed merely because participation has terminated.

  The objective, in changing from service to participation, seems worth restating. It was to prevent entrepreneurs from waiting to install plans until they themselves were almost ready to retire. There was concern that plans were being established for just a brief window period until the entrepreneur retired. In light of this objective we suggest these changes:

  a) Count participation in a DC prior to participation in a DB for both 415(b) and 415(e).

  b) i) Clarify that, in general, the DB fraction is not affected by cessation of service or participation, or, if this is impossible,

     ii) Count participation in a DC following participation in a DB for 415(e) purposes and permit the same approach to projection that is permitted during DB participation.

  c) Permit the sponsor to establish participation retroactively, provided the approach is taken consistently and former employees are included.

This last proposal is admittedly not new. We made it originally a year ago. Nevertheless, we are hopeful that with all the consternation which has accompanied the change from service to participation, there will be a receptiveness to proposals for modification.

SEC. 111(g)

- Revise 401(l) so that for offset plans the key factor is the Primary Insurance Amount calculated under reasonable rules incorporated in the plan, rather than "Final Average Compensation".

- Restore the former degree of permitted disparity for Social Security integration purposes, but restore the requirement that adjustments be made for ancillary benefits. Restoration of the former degree of permitted disparity would require increasing each .75 factor to about 1.07. The current format of 401(l) encourages plan design which incorporates rich ancillaries.

SEC. 111(h)

- This item deals with 401(a)(26). We believe this section has demonstrated itself to have more extensive impact than was originally contemplated. We continue to believe that 401(a)(26) is not good policy and should be repealed. Short of that, many problems could be avoided by supplemental legislative history. This would reverse the legislative history which is there now, and establish that a single plan involving multiple benefit formulas may be treated as a single plan.

The definition of a single plan would involve the concept that there is no partitioning of fund assets. That is, all assets would be available to meet liabilities respecting all groups of participants under the plan.

SEC. 111(j)

- Establish a single definition of family member status. The new one proposed for utilization with the $200,000 limitation of 401(a)(17) and 404(l), would seem totally satisfactory as the only one for all purposes.

SEC. 111(m)

- Clarify that a plan is not required to specify how qualified matching and qualified non-elective contributions will be assigned between (k)(3) and (m)(2) tests. That is, the plan sponsor may dictate assignment from year to year.

The resultant discretion is merely analogous to the discretion involved in assigning deductible contributions under 404(a)(7).

SEC. 111(B)

- Delete the proposed 89 change respecting the rule permitting application of the 50/90 test separately to dependent coverage, ignoring employees without dependents.

Under the proposed change, separate testing would be precluded, but employees without dependents could be treated as if they had dependents and dependent coverage. This change would require imposition of a discretionary test. While the illustration at Page 145 of the Joint Committee description seems clear, there will be many borderline cases. The thrust has been in the direction of bright line tests. There seems to be no reason why this thrust should be abandoned, here.

We are not impressed by the proposition that the change would relieve employers of much of a burden. An employer these days who does not keep records on employee family status is courting trouble. However, if some folks disagree with us, it might make sense if utilization of the proposed change were available on an optional basis.

- Under 89, change the definition of employer financed benefit associated with definitions of comparable plans for purposes of the 80% test. Provide that salary reduction contributions are treated as employee contributions. This change would accommodate employers who have been satisfying the HMO Act by establishing a fixed employer contribution and varying employee contributions. At present, these employers will probably be able to satisfy the 80% test if employee contributions are accepted on an after-tax basis. But they may have trouble if they have utilized 125 to accept employee contributions on a before-tax basis.

- Provide a mandate that benefit valuation rules under 89 be consistent with rules for determining compliance with the HMO Act. We are concerned that 89 benefit valuation procedures may be adopted which ignore the question of whether coverage is through an HMO. This could lead to a situation where compliance with the HMO Act will make it difficult to satisfy 89.

PROPOSED CHANGES IN TECHNICAL CORRECTIONS BILL

PART II

SEC. 111(d)

Code Section 415(e): If these overly complex rules are to be retained, additional transitional rules should be provided. The calculation of the defined contribution fraction involves a great deal of historical data which in many cases has not been retained because it was clear, based on the prior limitations, that the restrictions would not apply. As a result of the significantly reduced defined benefit limit, many more individuals are potentially affected by the dual plan limits. This will undoubtedly generate significant administrative and auditing costs.

COLA on $200,000 Compensation Limit: The explanation to the proposed Technical Corrections Act indicates that this COLA starts in 1990 for post-1988 increases. However, Code Section 401(a)(17) indicates that this COLA is to be adjusted at the same time and in the same manner as under Section 415(d) which in turn provides for post-1987 increases.

SEC. 111(g)

Social Security Retirement Age: The definition of the Social Security Retirement Age to be used for Code Section 415 is fashioned by reference to the Social Security Act "without regard to the age increase factors". This translates to truncating the Social Security Retirement Ages to the next lowest full year. This is contrary to the ages specified in the Senate Finance Committee explanation which apparently were intended according to Congressional staffers.

SEC. 111(h)

Minimum Participation Rule: Code Section 401(a)(26) provides that the new minimum participation rule must be satisfied on each day of the Plan Year. This is difficult to test from the plan administrator's point of view as well as difficult for the IRS to audit. Satisfaction of the rule on the first and/or last day of the Plan Year should be sufficient.

Minimum Participation Rule - Terminations and Mergers: Guidance is requested regarding the applicability of the "eligible amount" in the context of a plan merger in response to the minimum participation rule where two or more defined benefit plans are merged. Funds are not earmarked or distributed to plan participants in any way, nor are excess assets refunded to the employer. Unless a plan termination is undertaken in conjunction with a merger, it would seem that the reversion penalty and "eligible amount" restrictions are not relevant. As a result there is no need to reference mergers in the statute.

With respect to the actual determination of the present value, the rule should be clarified due to the change in the rate under Code Sections 401(a)(11) and 417. Plans which used the PBGC immediate annuity interest rate in accordance with IRS regulations and subsequently changed to the PBGC deferred annuity interest rate to conform to the 1986 Tax Reform Act should not be viewed as having changed their rate after August 16, 1986.

SEC. 111(j)

$200,000 Compensation Limitation: The proposed Technical Corrections Act clarifies the application of the $200,000 compensation limitation for purposes of the family member aggregation rules with respect to Plan Years beginning after December 31, 1988. A similar clarification is needed for applying the $200,000 cap for purposes of the 401(k) and 401(m) testing of top-heavy plans for 1987 and 1988 Plan Years.

$200,000 Compensation Limitation - Integration Rule: Guidance should be provided regarding the allocation of compensation in excess of the family group's aggregated integration level. The proposed Technical Corrections Act explains how the family members are added together, but does not explain how the resulting contribution/benefit (individually limited to $30,000/$90,000) is apportioned to the individuals.

SEC. 111(l)

Withdrawals from 401(k) Principal: Given that hardship withdrawals are limited to 401(k) contributions and not the investment experience attributable such contributions, computer systems must be modified to accumulate such amounts. It would be helpful if the account balance prior to the effective date of the new rule were grandfathered so that administrators need not reconstruct the information with respect to prior Plan Years.

SEC. 111(m)

Determination of Highly Compensated Employees: Unlike the determination of key employees under the top-heavy rules where individuals are identified as of the last day of the preceding Plan Year, the Highly Compensated Employee determination cannot be finalized until the end of the Plan Year for which the discrimination and coverage test are to be applied due to new hires, terminees, pay raises and bonuses. This is a significant stumbling block to attempts to monitor the 401(k) and 401(m) tests so as to avoid the need to make refunds and pay the 10% penalty. Adoption of the top-heavy approach, using the two Plan Years preceding the Plan Year to be tested, would alleviate this problem for administrators.

7,000 Deferral Limit: Although plans are not required to make refunds as requested by employees, some practitioners believe there may be a fiduciary duty to do so. However, other rules may make it impossible to provide the refund even if the employer is willing to do so. For example, since the refund is deemed to come from the first contributions of the calendar year (typically), a refund to a non-highly compensated employee could reduce the average deferral percentage for highly compensated employees with respect to a Plan Year which has already ended. A refund to a highly compensated employee will apparently require the forfeiture of the match which has already been allocated and communicated with respect to a prior Plan Year. These problems would be alleviated if the plan is permitted to treat the distribution as an in-service withdrawal and is not required to adjust prior valuations in any way.

SEC. 111(A)(b)

Partial Rollover Rule: In redrafting this rule under Code Section 402(a)(5) to reference the "lump sum distribution" under 402(e), language dealing with the balance at the time of the distribution was dropped. Was this intended? Frequently we see benefits distributed in two payments which often straddle two calendar years. A terminee is permitted to draw down his fixed income account, for example, but must wait until after the end of the valuation period to be paid his equity account. It would seem to further portability objectives to permit the rollover of both payments, but this is not clear from the statute.

SEC. 111(A)(f)

Tax on Excess Distributions: A clarification would be appreciated regarding the imposition of the Section 4981A tax on investment experience attributable to a participant's August 1, 1986, accrued benefit or account balance. If an individual has no additional benefit accrual or contribution after August 1, 1986, is the distribution of the entire benefit or account balance at a later date exempt or are the investment earnings subject to the tax?

SEC. 118(q)

Retirement Equity Act Technical Corrections: The five year repayment period was a welcomed clarification. However, the IRS apparently interprets Code Section 411 as requiring a cash-out or a five year break-in-service prior to the forfeiture of a terminated employee's forfeitable benefit. In most cases terminees are not rehired by the same employer. As a result the only way to access a forfeitable benefit is to cash-out the nonforfeitable benefit. This runs contrary to the objective of retaining the benefits for retirement purposes. Employers should be permitted to retain the nonforfeitable benefit in the plan while using the forfeitable portion for reallocation or the reduction of the required employer contribution as long as arrangements are made for restoring the forfeiture in the unlikely event the individual returns. Note that the immediate use of such forfeitures will have a favorable impact on the budget to the extent used to reduce current employer contributions.

SUMMARY OF PROPOSED TECHNICAL CORRECTION OF SECTION 1317 (27)(I) OF THE TAX REFORM ACT OF 1986 FOR THE TOWN HALL OF ANDOVER, MASSACHUSETTS

The Town of Andover, Massachusetts received a transition rule under Section 1317(27)(I) from the Tax Reform Act of 1986 to assist in the restoration and rehabilitation of the Andover Town Hall built in 1858.

The transition rule provided for an exemption from Section 149(b) of the 1986 Code relating to federally guaranteed obligations but did not exempt the project from Section 144 regarding the $10 million capital expenditure limitation for small issue bonds in a municipality by a "principal user". The Town of Andover is the location for the Internal Revenue Regional Service facility which has capital expenditures in excess of $10 million in the six year period examined for determining the aggregate amount of capital expenditures by a principal user in a municipality. The U.S. government will be a principal user because a portion of the project will be used for a U.S. Post Office. The anticipated $2.6 million bond issue for the rehabilitation of the Town Hall, when aggregated with the capital expenditures by the federal government with respect to the IRS service center and possible other federal facilities, would exceed the $10 million limit and thus would disqualify the bonds from tax exempt status. Although a technical correction was proposed in Section 113(g)(27) of S. 1350 to exclude the Internal Revenue Service facility, other federal facilities may have capital expenditures or other tax exempt facility-related bonds allocable to the United States Government which may affect the tax exempt status.

The technical correction is necessary to exempt the $2.6 million bond issuance by the Town of Andover. The technical correction will not result in a revenue loss to the government but will merely enable the Town to accomplish what was originally intended.

The following technical correction is proposed with the new language underlined.

Proposed Amendment to Section 113(g)(27) of the S. 1350:

> (27) Subparagraph (I) of section 1317(27) of the Reform Act is amended by adding at the end thereof the following: "For purposes of determining whether any bond to which this subparagraph applies is a qualified small issue bond, there shall not be taken into account under section 144(a) of the 1986 Code capital expenditures with respect to any ~~internal revenue service center~~ <u>facilities of the United States government and all other tax exempt facility-related bonds allocable to the United States government</u>."

Proposed Technical Correction For The Andover, Massachusetts Town Hall in Regard To Section 1317 (27)(I) Of The 1986 Tax Reform Act And The Technical Correction Contained In Section 113(f)(27) of S. 1350

The Town of Andover, Massachusetts greatly appreciates the efforts of the United States Congress in providing a transition rule for the purpose of providing tax exempt bond financing for the restoration and rehabilitation of its Town Hall which was built in 1858. The Town of Andover received a transition rule in Section 1317(27)(I) of the Tax Reform Act of 1986 to provide for tax exempt bonds to assist in restoration and rehabilitation of this historic facility. A copy of the transition rule is attached. When the transition rule was obtained no one foresaw the capital expenditure limitation for small issue bonds as a problem because of the uniqueness of the project.

After the citizens of Andover approved the bonds for the project, it became apparent that a technical correction was necessary. Bond counsel and the Internal Revenue Service believed the provision would not fully exempt the facility from certain limitations which apply to qualified small issue bonds.

The principal user of the rehabilitated Town Hall will be the federal government because the United States Post Office will be the major tenant of the restored building. The post office was one of the original tenants in 1858. Because the Town Hall will be used by the Federal government (which is a non-exempt person for purposes of the Internal Revenue Code of 1986 (the "Code")), the bonds issued to finance the project must be issued as "qualified small issue bonds" under Section 144(a) ot the Code. It is necessary under Section 144(a) to calculate capital expenditures with respect to all other facilities located in the same municipality the principal user of which is or will be the same as the principal user of the bond-financed facilities, over a six year period beginning three years before the date of the bond issue and ending three years after such date. The face amount of the qualified small issue bonds, together with all such capital expenditures, cannot exceed $10,000,000. Therefore, all capital expenditures with respect to other facilities of the federal government located in Andover must be examined because they must be aggregated with the principal amount of the bonds.

The technical correction as introduced in S. 1350 Section 113(f)(27), as discussed below, provides for a technical correction which exempts the capital expenditures related to the Internal Revenue Service Regional Service Center located in Andover from the capital expenditure limitation. Andover had requested in letters to members of the Massachusetts delegation that Section 144(a) relating to qualified small issue bonds not apply to the project because Andover knew that the federal government probably spent in excess of $10,000,000 on the Regional Service Center. A copy of the proposed language as contained in the summary to the delegation is attached which was submitted to Senators Kennedy and Kerry and Congressmen Atkins, Conte and Donnelly.

Andover's bond counsel is concerned that other federal facilities or projects may also have capital expenditures that will count towards the $10,000,000 capital expenditure limitation. The other facilities in Andover in which the federal government has incurred or will incur capital expenditures are the present post office on Main Street and two post office substations in Shawsheen and Ballardvale, and a new replacement postal facility presently under construction. In addition, the published and private rulings by the Internal Revenue Service define the term "capital expenditures" so broadly that many other expenditures by the federal government may have to be taken into account.

In general, the term "capital expenditures" includes all costs which are <u>or might be</u> capitalized under <u>any</u> accounting theory or tax provision. Thus, in determining whether the $10,000,000 limit is exceeded, the Town might have to include not only expenditures with respect to offices and other facilities of any other federal agencies located in Andover, but also federal funds for the interstate highways located in Andover, all federal grants and loans made with respect to facilities or other projects or undertakings in Andover, and possibly even federal contracts awarded to government contractors located in Andover. It would be difficult enough to try to calculate the amount of all such expenditures by the federal government in Andover over the past three years. It will be impossible to keep track of, and restrict, if necessary, the amount of such expenditures by the federal government over the next three years, in order to make sure that the aggregate of such expenditures, when taken together with the principal amount of the bonds, does not exceed $10,000,000. If the federal government were to incur additional capital expenditures with respect to other facilities in Andover during the three year period after the bond issue, causing the $10,000,000 limit to be exceeded, the single bond issue for the Town Hall would automatically lose its tax-exempt status at that point. Since the Town of Andover cannot control, and would not want to limit, future capital expenditures by the federal government in Andover, the only solution that would assure continued tax exemption for the bonds would be to exclude all such capital expenditures by the federal government from the $10,000,000 limit.

However, we are deeply concerned that the term "capital expenditures" may be broadly defined by the Internal Revenue Service to include all federal funds spent in Andover and possibly prohibit tax exempt financing for the Town Hall.

In addition, under Code Section 144(a)(10) a $40,000,000 limit is imposed on all other tax exempt bonds issued to finance other facilities owned or used by the same principal user, in this case the federal government. Such other bonds will have to be aggragated with these bonds and would have to be less than the $40,000,000 limit for these bonds to remain tax exempt. Accordingly, the technical correction must also exclude such other tax exempt bonds allocable to the federal government.

Andover respectfully requests that the technical correction as contained in Section 113(f)(27) of S. 1350 be amended to read as follows:

> (27) Subparagraph (I) of section 1317(27) of the Reform Act is amended by adding at the end thereof the following: "For purposes of determining whether any bond to which this subparagraph applies is a qualified small issue bond, there shall not be taken into account under section 144(a) of the 1986 Code capital expenditures with respect to any ~~internal revenue service center~~ facilities of the United States government and all other tax exempt facility-related bonds allocable to the United States government."

This proposed technical correction would eliminate any concern in the future for expenditures that may be undertaken by the federal government in Andover or tax exempt bonds that may be issued for facilities that may be used by the federal government that might affect the tax exempt status of the bonds.

Andover is not requesting any additional funds but is only requesting that Congress' intent to provide tax exempt funding for this small but important restoration project be fulfilled.

Respectfully submitted,

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EXCERPT FROM CONFERENCE REPORT 99-841
TO ACCOMPANY H.R. 3838

The aggregate face amount of obligations to which this subparagraph applies shall not exceed $8,500,000.

(I) A facility is described in this subparagraph if it consists of the rehabilitation of the Andover Town Hall in Andover, Massachusetts. The provisions of section 149(b) of the 1986 Code (relating to federally guaranteed obligations) shall not apply to obligations to finance such project solely as a result of the occupation of a portion of such building by a United States Post Office.

(J) A facility is described in this subparagraph if it is the Central Bank Building renovation project in Grand Rapids, Michigan. The aggregate face amount of obligations to which this subparagraph applies shall not exceed $1,000,000.

(28) CERTAIN PRIVATE LOANS NOT TAKEN INTO ACCOUNT.—For purposes of determining whether any bond is a private activity bond, an amount of loans (but not in excess of $75,000,000) provided from the proceeds of 1 or more issues shall not be taken into account if such loans are provided in furtherance of—

(A) a city Emergency Conservation Plan as set forth in an ordinance adopted by the city council of such city on February 17, 1983, or

(B) a resolution adopted by the city council of such city on March 10, 1983, committing such city to a goal of reducing the peak load of such city's electric generation and distribution system by 553 megawatts in 15 years.

(29) CERTAIN PRIVATE BUSINESS USE NOT TAKEN INTO ACCOUNT.—

(A) The nonqualified amount of the proceeds of an issue shall not be taken into account under section 141(b)(5) of the 1986 Code or in determining whether a bond described in subparagraph (B) (which is part of such issue) is a private activity bond for purposes of section 103 and part IV of subchapter B of chapter 1 of the 1986 Code.

(B) A bond is described in this subparagraph if—

(i) such bond is issued before January 1, 1993, by a State admitted to the Union on June 14, 1776, and

(ii) such bond is issued pursuant to a resolution of the State Bond Commission adopted before September 26, 1985.

(C) The nonqualified amount to which this paragraph applies shall not exceed $150,000,000.

(D) For purposes of this paragraph, the term "nonqualified amount" has the meaning given such term by section 141(b)(8) of the 1986 Code, except that such term shall include the amount of the net proceeds of an issue which is to be used (directly or indirectly) to make or finance loans (other than loans described in section 141(c)(2) of the 1986 Code) to persons other than governmental units.

(30) VOLUME CAP NOT TO APPLY TO CERTAIN FACILITIES.—For purposes of section 146 of the 1986 Code, any exempt facility bond for the following facility shall not be taken into account: The facility is a facility for the furnishing of water which was authorized under Public Law 90-537 of the United States if—

PROPOSED TECHNICAL CORRECTION OF Section 1317 (27)(I) THE TAX REFORM ACT OF 1986

The Town of Andover, Massachusetts received a transition rule under Section 1317 (27) (I) from the Tax Reform Act of 1986 to assist in the restoration and rehabilitation of the Andover Town Hall built in 1858. The rehabilitation is to retain the integrity of design, materials, workmanship, and setting of the old town hall and to utilize the facility as a post office.

The transition rule provided for an exemption from Section 149(b) of the 1986 Code relating to federally guaranteed obligations but did not exempt the project from Section 144 regarding the $10 million on capital expenditures limitation for small issue bonds in a municipality by a "principal user". The Town of Andover is the location for the Internal Revenue Service facility which has capital expenditures in excess of $10 million in the six year period examined for determining the aggregate amount of capital expenditures by a principal user in a municipality. The U.S. government will be a principal user because a portion of the project will be used for a U.S. Post Office. The anticipated $2.6 million bond issue for the rehabilitation of the town hall, when aggregated with the capital expenditures by the federal government with respect to the IRS service center, would exceed the $10 million limit and thus would disqualify the bonds from tax exempt status.

The technical correction is necessary to exempt the $2.6 million bond issuance by the Town of Andover. The technical correction will not result in a revenue loss to the government but will merely enable the Town to accomplish what was originally intended.

A specific exception to the statewide volume cap limitation is also necessary to insure the availability of funding.

The following technical correction is proposed with the new language underlined.

Proposed Amendment to Section 1317 (27)(I) of the Tax Reform Act of 1986:

(I) A facility is described in this subparagraph if it consists of the rehabilitation of the Andover Town Hall in Andover, Massachusetts. The provisions of <u>Sections 144(a) and 146 (relating to qualified small issue bonds and volume cap respectively) shall not apply to obligations to finance such project for any purpose. The provisions of</u> 149(b) of the 1986 Code (relating to federally guaranteed obligations) shall not apply to obligations to finance such projects solely as a result of the occupation of a portion of such building by the United States Post Office.

STATEMENT TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE REQUESTING THE INCLUSION OF RULES CONCERNING ANNUITY AND LIFE INSURANCE CONTRACTS WITH MARKET VALUE ADJUSTMENT PROVISIONS IN S. 1350, THE PROPOSED TECHNICAL CORRECTIONS ACT OF 1987

On behalf of an ad hoc committee of 13 life insurance companies concerned with the Federal income tax treatment of insurers issuing annuity and life insurance contracts with market value adjustment provisions, we appreciate the opportunity to submit this statement for inclusion in the record of the Subcommittee's July 22, 1987 hearing on S. 1350, the proposed Technical Corrections Act of 1987. As detailed below, we request that the Committee on Finance, in connection with its consideration of S. 1350, include as technical changes to part I of subchapter L, chapter 1, of the Internal Revenue Code of 1986 (the "Code") certain rules that we believe to be needed in order to assure a rational tax treatment of life insurance companies with respect to certain annuity contracts that they issue (as well as life insurance contracts that they may issue) that contain market value adjustment provisions. A list of the member companies of the ad hoc committee accompanies this statement.

I. Introduction: The "MGA" and State Regulation

As enacted in 1984, section 807(d)(1) of the Code provides that the amount of the life insurance reserve for any contract is the greater of the contract's "net surrender value" or its reserve computed under the so-called "Federally prescribed reserve" rules of section 807(d)(2). Further, if the contract requires a "market value adjustment" of its cash value if surrendered prior to maturity, section 807(e)(1) of the Code provides that its net surrender value for this purpose is determined without regard to any such adjustment. The amount of the reserve as so determined is sometimes referred to as the "tax reserve." This tax reserve amount for any contract is further limited, under the last sentence of section 807(d)(1), to the contract's "statutory" or annual statement reserve. However, for reasons noted below, the reserve rules as enacted in 1984 failed to exclude the effect of a market value adjustment from this annual statement limitation.

A. The Contracts

In keeping with the development that led to inclusion of the market value adjustment rule in section 807(e)(1), insurers have begun to issue both individual and group annuity contracts, based on market-valued separate accounts established under state law, that combine guaranteed features with market value adjustment provisions. This type of contract, referred to as the "Modified Guaranteed Annuity" or "MGA" in accordance with the name of one of the product's prototypes, provides at maturity the typical guarantees of principal and interest earnings found in individual or group deferred annuity contracts written through an insurer's general account. In addition, as a feature that is generally new for such contracts, a market value adjustment is included, that is, the contract's cash value on surrender prior to its maturity date is adjusted to reflect market fluctuations. (It would be possible, of course, to design a life insurance contract with such a market value adjustment feature, although, to the knowledge of the members of the ad hoc committee, to date no insurer has issued such a contract.)

Unlike variable contracts written though an insurer's separate account, direct linkage of market value fluctuations in separate account assets to benefits under MGA contracts is not contemplated, nor is reflection of the earnings on specific assets even attempted (the interest earnings under MGA contracts are guaranteed). Rather, by means of a contractual formula that relates current market interest rates (at the time of a pre-maturity surrender) to the rates guaranteed under the MGA contract, the cash surrender value is adjusted upward or downward, much like the change that occurs in the principal value of a marketable bond as interest rates change. More precisely, as defined in a New York Department of Insurance regulation relating to market value adjustments under deferred annuities, such a formula "is described in the contract for increasing and decreasing the actual accumulation amount [the premiums accumulated with interest and any dividends, less certain charges under the contract] in order to determine cash surrender benefits and which takes into account (1) changes in interest rates on publicly-traded obligations or other investments or in interest rates provided in, or declared pursuant to, contracts of the same class as the contract being surrendered and (2) the length of time between the date on which the contract is surrendered and the next date on which the contract would have provided cash surrender benefits determined without the use of any market-value adjustment formula."

Thus, an MGA contract with a guaranteed interest rate that is higher than the current market rate for "similar" investments (i.e., similar to those described in the adjustment formula) can have an immediate cash surrender value higher than the contract's accumulated value on its guarantees alone. On maturity of the contract, however, only the guaranteed value is provided, regardless of the then market value of the insurer's assets. Moreover, the closer one moves toward the contract's maturity date, the more limited will be the impact of the cash value adjustment.

B. NAIC Model Regulation

In June, 1985, the NAIC adopted a model regulation governing MGA contracts which directs that a portion of the assets of an insurer issuing MGAs be placed in a separate account. Under the regulation, the assets in the separate account are valued at market rather than at amortized cost (or "book"), unrealized gains and losses on the separate account assets are included in determining the insurer's statement gain or loss from operations, and the reserves relating to the MGAs are required to be calculated such that they reflect the market value of the liabilities under the contracts. This was done, in part, to provide insurers issuing such contracts a means of avoiding potential surplus strain. Such strain would result, in the case of guaranteed contracts (with or without market value adjustment provisions) accounted for in an insurer's general account, from the fact that at a time of rising interest rates, the insurer's assets are nonetheless valued at book and its liabilities for those contracts are valued on the usual statutory basis.

This model regulation is currently under consideration in various States. While the regulation itself has not yet been adopted by any State, New York has enacted legislation, and Connecticut has adopted a regulation, permitting the assets and reserves for MGAs to be accorded separate account treatment, with market valuation of assets and reserves. A similar model regulation has been adopted by the NAIC, and corresponding legislation has been enacted in New York, relating to life insurance contracts with market value adjustment provisions, although, as indicated above, it appears that no such contracts have yet been issued.

II. Problems and Proposed Solutions

The separate account approach taken by the NAIC model regulation (and in the versions of the model adopted in New York and Connecticut) poses several significant tax problems for insurers issuing MGAs. Specifically, problems arise with respect to (1) the reserve rules under section 807(d), (2) the computation of the "equity base" under section 809(b), and (3) the determination of the "statement gain or loss from operations" under section

809(g)(1). Similar problems would arise in the case of life insurance contracts with market value adjustment features accounted for in a separate account. Each of these is discussed below, together with a proposed solution.

A. Reserves

1. Problem

Adhering to the approach of the model regulation would mean, first of all, that the tax reserves for an MGA contract would potentially be limited to an amount that is less than the contract's guaranteed value without regard to the market value adjustment. This stems from the twin facts that (1) the model regulation permits annual statement reserves for MGAs to be as low as the market-adjusted surrender value, even when that value reflects unrealized losses due to depressed market values generally, and (2) section 807(d)(1) restricts the amount of the tax reserves to the amount reported on the annual statement. Thus, due to a decrease in market values and a corresponding decrease in the MGA separate account's annual statement reserves, an insurer's tax reserves may also decrease -- even though its liability on the contract's maturity remains unchanged -- and the net result is "income" to the insurer for tax purposes.

An example may help to illustrate the source and nature of this problem. Assume that an insurer issued an MGA contract on January 1 of a given year in consideration of a $100 premium, and that by December 31 the market value adjustment formula in the contract required a downward adjustment of $10. Disregarding any reserve increase attributable to interest credits (the income and deductions for which are offsetting amounts), the insurer's year-end liability for the contract's maturity value, discounted to present value without regard to the market value adjustment (i.e., using a general account approach), would be $100. Under the model regulation, however, its required annual statement reserve would be reduced by $10 to only $90. Hence, while the insurer would have taxable income with respect to the contract of $100 (in premium) and while its deduction for the net surrender value without regard to the market value adjustment (under section 807(d) and (e)) would otherwise be an offsetting $100, that deduction would in fact be restricted to $90 by virtue of the annual statement reserve limitation imposed by the last sentence of section 807(d)(1). As a result, even though it earned nothing from the transaction, the insurer would show taxable income of $10.

Such a result runs contrary to the thrust of the 1984 life company tax legislation, which endeavored to minimize tax accounting distortions. For general account contracts in particular, section 807(e)(1) sought to minimize distortions due to pre-maturity surrender value fluctuations by requiring that surrender values, for tax reserve purposes, be determined without regard to market value adjustments. In the case of a pension plan contract, section 807(e)(1)(B) expressly states that the net surrender value deductible for tax purposes -- which it declares to be the policyholder's fund for such a contract -- is to be determined "without regard to any market value adjustment", and for all other types of contracts section 807(e)(1)(A)(ii) provides a parallel rule. The purpose of these provisions is clear: to provide reserve deductions for contracts with market value adjustments in a manner that recognizes the essential character of the contracts as guaranteed.

Thus, while the tax treatment of the life insurer issuing an MGA type of contract through its general account was fully and adequately addressed in the provisions of section 807 as revised in 1984, those provisions (as well as the section 809 rules) do not assure a sensible treatment of the life insurer issuing such a contract through one of its separate accounts. Indeed, because the MGA is essentially a guaranteed contract and does not promise the policyholder a cash value or other benefits reflecting market fluctuations of, or earnings on, the separate account asset values, the variable contract separate account rules of section 817 of the Code (which otherwise deal with tax accounting distortions) by their terms do not apply. Hence, there is no assurance that when pre-maturity fluctuations in the MGA separate account's market-valued reserves and assets result in additional income or deductions under the section 807 (or section 809) rules, a sensible matching of revenues and expenses will occur. In the case of section 807 in particular, the potentially distorted treatment arises from the failure to extend the section 807(e)(1) concept to the determination of the annual statement reserve limitation imposed by the last sentence of section 807(d)(1). At the time of the 1984 legislation, of course, there was no known need for such an extension.

No insurer can afford to issue a significant volume of business the tax treatment of which is so unpredictable and arbitrary. Moreover, from a standpoint of sound tax policy, it is at least questionable whether potential variations in separate account reserves for MGAs from company to company, and from State to State, should be reflected without modification in the tax reserve computations. Such variations could appear, for example, due to the absence of a uniform method of valuing liabilities "at market" or to the fact that some States may adopt, and others may not adopt, either the NAIC model regulation approach or some modification of it. Such variations would seem most troubling in light of the principal thrust of the section 807(d) rules to provide a more uniform treatment of reserves for tax purposes.

2. Proposed Solution

This situation can be remedied by changing the rule set forth in the last sentence of section 807(d)(1), to modify it in a manner that implements the concept of section 807(e)(1). It would certainly make sense to extend that concept to the section 807(d)(1) rule, particularly since, in the case of an MGA with separate account reserves, failure to do so would nullify the intent underlying section 807(e)(1) to permit a reserve deduction measured in part by a contract's surrender value before application of any market value adjustment. More to the point, without such a conforming change, the tax treatment of MGAs (and of life insurance contracts similarly accounted for) decidedly will not make sense, giving rise to anomalies in company taxation.

Accordingly, the reference to "statutory reserves" found in section 807(d)(1), which imposes the annual statement limitation on the amount of the tax reserves, should be amended to specify that, in the case of MGAs and life insurance contracts with market value adjustment features accounted for in a separate account, this limiting reserve amount is to be determined as if the reserve were held in the general account. Thus, the rule should provide that where an insurance or annuity contract is based on a separate account under State law or regulation, but is not a variable contract described in section 817(d), the reference to statutory reserves will be taken to mean the reserves that would be held for the contract in the general account (as if the contract contained no market value adjustment features). This would mean, employing the same illustration used above, that the annual statement reserve (as a limit) would be deemed to be $100 at year-end, providing a proper tax accounting for the contract: $100 of income, $100 of reserve deductions, and no resulting taxable income (since there was no real gain to the insurer) arising out of accounting distortions.

It should be noted that this proposed solution in no way detracts from the constraints on tax reserves adopted in the 1984 legislation. Under the proposal, the standards of section 807 and section 811(d) (relating to reserves for contracts with excess interest guaranteed beyond the end of the taxable year) are readily applied to determine the amount of the tax reserve, without regard to the annual statement limit before it is re-determined on a general account basis. All that the proposal does is to free the tax treatment from a "limit" which is depressed by unrealized losses and which, without the proposed change, would restrict the tax reserve to an amount less than that needed to mature the contract as guaranteed. In this connection, it is noteworthy that when market values rise, there is no corresponding increase in the tax reserve because, under section 807(e)(1), the net surrender value of a contract is computed without regard to any market value adjustment. The proposal thus would carry out the recognition, otherwise found in the rules of section 807(d) and (e), that the amount of an insurer's obligation is correctly measured for tax purposes by disregarding market value adjustments, positive or negative.

It should also be noted that the "limit" under the proposal, like any annual statement reserve for an insurance or annuity contract issued through the general account, would be the greater of the present value of the future benefits or the surrender value of the contract. For this purpose, the new reserve "limit" would be determined under the normal rules, regulations, and actuarial principles applicable to the calculation of annual statement reserves (e.g., state law and regulations, NAIC rules, separate account rules, etc.). In the case of the typical MGA contract, under those rules the surrender value of the contract, if issued through the general account, would be determined without regard to any market value adjustment, and thus, effectively, the limit under the proposal would equal the contract's discounted future benefits. In the case of other separate account contracts not described in section 817(d), however, the surrender values could be greater than the present value of the future benefits. This might be true, for example, in the case of a variable life insurance contract which (for some reason) fails to qualify under the section 817(d) definition. In such a case, the total general account reserve for the contract (and, accordingly, the new limit under the proposal) would be the greater surrender value, in accordance with applicable NAIC general account reserve requirements, together with any actual general account reserves associated with the contract (due to the insufficiency of separate account assets to satisfy contractual guarantees).

As a final point, a requirement similar to that found in new section 846(b)(2) of the Code (relating to undiscounted unpaid losses) could be added to the foregoing proposal, if considered helpful. Such a requirement would stipulate that, for any amount of a reserve beyond that appearing in the separate account to be recognized for tax purposes, it must be shown in a note in or accompanying the annual statement.

B. Equity Base

1. Problem

Use of the separate account approach under the NAIC model regulation, in that it takes market fluctuations into account in valuing liabilities and assets, would also pose two problems in determining the "equity base" under section 809(b). The equity base consists of a company's surplus and capital, with certain adjustments, valued as provided on the company's annual statement.

First, assets held in the general account of the company generally are valued at amortized cost or "book," disregarding market fluctuations, and this treatment is applied in determining the equity base for purposes of section 809. However, assets held in separate accounts under the model regulation will be valued at market. Thus, because of the model regulation's approach, the equity base of a company issuing MGAs would also tend to vary in value, reflecting unrealized appreciation or depreciation in asset values even though this would not be reflected in the equity base if the assets were held in the general account.

The distorting effect that this would have on the equity base computation can be illustrated by expanding the prior example. Assume that the $100 premium received by the insurer on January 1 was invested in separate account assets that depreciated in value to $95 as of December 31. (Note that the change in the value of the assets may not mirror the change in the reserves.) As a result, the amount of the insurer's equity base under section 809 would decrease by $5. This would be an unrealized $5 loss, however, and would not decrease the equity base if the assets were held in the insurer's general account.

A second equity base concern relates to the treatment of reserves. Under current law, if annual statement reserves exceed tax reserves, this excess is added to the equity base. In this manner, the equity base is calculated using tax reserves rather than statutory reserves. There is, however, no corresponding rule permitting the equity base to be reduced when the contrary is true, i.e., to decrease the equity base by any excess of tax reserves over annual statement reserves. This situation could arise, of course, in light of the amendment needed in the reserve rules as described in 1. above. Therefore, in the prior example, unless current law is changed, equity would be overstated by $10, in that statutory reserves would be only $90 whereas tax reserves would be $100.

2. Proposed Solution

The concept of according general account treatment to the tax accounting for contracts (whether annuity or life insurance contarcts) with market value adjustments, disregarding unrealized fluctuations in values, should also apply for purposes of section 809. This would avoid the distorting effects just described and give full effect to the intent of Congress when it made use of that concept in crafting the section 807(e)(1) rule. Accordingly, section 809(b) should be amended in two respects. First, a provision should be added directing that the amount of a company's surplus and capital be adjusted to remove any appreciation or depreciation in its non-section 817 separate account assets that would not be included in the surplus and capital if those assets were held in the company's general account. This would provide the authority needed to add back the unrealized $5 to the equity base in the example above. Second, section 809(b)(4), which currently includes in the equity base the excess of statutory reserves over tax reserves, should be broadened to cover the contrary situation -- reducing the equity base by the excess of tax reserves over statutory reserves -- where non-section 817 separate account contracts are involved. This would provide the authority to use tax reserves ($100) instead of statutory reserves ($90) in computing the equity base.

C. Statement Gain

1. Problem

Another problem arising from the model regulation's separate account treatment relates to the determination of the "statement gain or loss from operations" as defined in section 809(g)(1). The source of this problem is similar to that already described, namely, the annual statement's reflection of unrealized gains and losses in valuing assets for this type of contract. Thus, departing from the usual general account treatment, the model regulation would require the reflection of all gains and losses, whether or not realized, in computing annual statement gain or loss from operations.

As should be evident from the foregoing discussion, this, too, would produce distorted and illogical results if given effect for tax purposes. It would mean, using the same example as above, that the $5 in unrealized loss would decrease the statement gain figure under section 809(g)(1), despite its lack of realization by the company, or, correspondingly, that the statement gain would be increased for the amount of any unrealized gains.

2. **Proposed Solution**

As is the case with the definition of the equity base, the appropriate solution to this aspect of the problem would be to restate the statement gain or loss from operations utilizing the general account approach. Thus, with reference to non-section 817 separate accounts, section 809(g)(1) should be amended to require the determination of statement gain without regard to any unrealized appreciation or depreciation in the separate account assets that would not be included in statement gain if those assets were held in the general account.

III. Suggested Statutory Language

To implement the foregoing proposed solutions:

(1) The following sentence should be added at the end of section 807(d)(1) --

"For purposes of the preceding sentence, in the case of an insurance or annuity contract based on an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company but which contract is not described in section 817(d), the statutory reserve shall be determined as if such reserve were held in the general asset accounts."

(2) A new paragraph (7) should be added at the end of section 809(b), as follows:

"(7) ADJUSTMENT FOR APPRECIATION OR DEPRECIATION IN ASSETS OF CERTAIN STATE LAW SEPARATE ACCOUNTS. -- The amount of the surplus and capital shall be adjusted to remove any appreciation or depreciation in the assets held in an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company (other than an account all or part of the assets of which are accounted for as provided in section 817) which would not be included in the value of such assets if they were not segregated from the general asset accounts."

(3) Section 809(b)(4) should be amended to read as follows (re-lettering existing subparagraph (B) as "(C)"):

"(4) ADJUSTMENT FOR DIFFERENCE BETWEEN STATUTORY RESERVES AND TAX RESERVES. --

"(A) IN GENERAL. -- If the aggregate amount of statutory reserves exceeds the aggregate amount of tax reserves, the amount of the surplus and capital shall be increased by the amount of such excess.

"(B) SPECIAL RULE FOR CERTAIN STATE LAW SEPARATE ACCOUNT CONTRACTS. -- If the aggregate amount of statutory reserves is less than the aggregate amount of tax reserves, the amount of the surplus and capital shall be reduced by the amount of such deficit. The reduction under this subparagraph shall not exceed the amount by which --

"(i) the aggregate amount of tax reserves for insurance or annuity contracts based on accounts which, pursuant to State law or regulation, are segregated from the general asset accounts of the company but which contracts are not described in section 817(d), exceeds

"(ii) the aggregate amount of statutory reserves for such contracts."

(4) A new subparagraph (D) should be added at the end of section 809(g)(1), as follows:

> "(D) in the case of assets held in an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company (other than an account all or part of the assets of which are accounted for as provided in section 817), determined without regard to any unrealized appreciation or depreciation in such assets which would not be included in statement gain or loss from operations if such assets were not segregated from the general asset accounts."

IV. Effective Date

In general, the foregoing amendments should be made effective for contracts issued after December 31, 1986. However, several companies are already issuing a modest amount of MGAs, and it would be appropriate to accord them the ability to use the tax accounting rules provided under the amendments in order to avoid the distortions described above. Hence, the amendments should also apply to contracts issued before January 1, 1987, where the treatment of such contracts on any issuing company's tax return makes use of the amendments' rules.

V. Revenue Effect

Since life insurance companies cannot afford to issue any significant volume of these contracts without the proposed amendments to the Code, enactment of the amendments should have no significant revenue impact.

VI. Conclusion

For the foregoing reasons, we respectfully request the Committee on Finance to incorporate the indicated amendments into S. 1350, the proposed Technical Corrections Act of 1987, when it considers that legislation.

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July 24, 1987

Senate Finance Subcommittee on
Taxation and Debt Management
July 22, 1987

SUMMARY OF TESTIMONY

NICHCLAS A. VELIOTES, PRESIDENT
ASSOCIATION OF AMERICAN PUBLISHERS, INC.

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1. New section 263A contains an ambiguity that the Treasury interprets as denying book publishers a section 174 deduction for its prepublication "research or experimental" expenses ("R&D") in developing instructional, reference and professional materials. The TCA should amend section 174 to make it clear that book publishers, like other American businesses, are eligible to deduct these R&D costs.

2. The activity of book publishers in creating new instructional, reference, and professional works, involves efforts that, by their nature, clearly constitute R&D and that, for any other industry, would qualify for deduction under section 174. Under a vague regulation and a specific ruling, however, the IRS has attempted to deny these deductions to the book publishing industry.

3. In 1976 Congress enacted legislation (section 2119 of the 1976 Tax Reform Act) that blocked IRS' efforts to deny these deductions. The effect of the 1976 legislation has been to allow book publishers to deduct, as current expenses, their editorial and similar costs incurred in the process of developing new books, thereby maintaining equality with other industries.

4. Based on a footnote in the 1986 Conference Report, the Treasury now takes the position that the 1986 Act, by implication, repealed the 1976 protective statute (section 2119). It further insists that costs of developing printed materials are automatically excluded from section 174 treatment, regardless of the character of the materials or the development process involved.

5. Treasury's interpretation of section 263A singles out and discriminates against the publishing industry. For virtually all other industries, costs of developing new products can still be deducted currently as R&D costs under section 174. Book publishers, practically alone, would be denied these current deductions.

6. AAP, the major national association of book publishers whose members publish about 70% of the books sold in the United States, submits that Treasury's position (embodied in its temporary and proposed regulations) is inconsistent with the terms of both the 1986 Act and the 1976 legislation, as well as grossly unfair and contrary to sensible national policies and priorities.

7. AAP requests that the TCA include a provision clarifying that book publishers' R&D costs for instructional, reference, and professional materials are eligible for treatment as R&D costs under section 174. The clarification would apply only to these limited classes of publications. Further, it would be confined only to costs that clearly constitute R&D. Not within the purview of section 174, but instead subject to capitalization, would be the following: Advance royalty payments to authors and costs of actual manufacture of the books or other products, including platemaking costs (material, typesetting, film making and labor), as well as production costs (paper, ink, binding, jackets and labor).

Statement by

NICHOLAS A. VELIOTES
Association of American Publishers, Inc.
Washington, D.C.

HEARINGS BEFORE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

Room SD-215, Dirksen Senate Office Building
9:30 a.m., Wednesday, July 22, 1987

My name is Nicholas A. Veliotes, and I am President of the Association of American Publishers ("AAP"), the major national association of book publishers whose members publish about 70% of the books sold in the United States. I am accompanied by AAP's counsel, Mortimer Caplin, of the Washington law firm of Caplin & Drysdale.

Let me first summarize the views of the AAP on an issue of vital importance to the book publishing industry of this country:

1. New section 263A contains an ambiguity that the Treasury interprets as denying book publishers a section 174 deduction for its prepublication "research or experimental" expenses ("R&D") in developing instructional, reference and professional materials. The TCA should amend section 174 to make it clear that book publishers, like other American businesses, are eligible to deduct these R&D costs.

2. The activity of book publishers in creating new instructional, reference, and professional works, involves efforts that, by their nature, clearly constitute R&D and that, for any other industry, would qualify for deduction under section 174. However, Treasury Regulations § 1.174-2(a)(1)--for some vague and unexplained reason--generally denies section 174 deductions for expenditures for "research in connection with literary, historical, or similar projects." And the Internal Revenue Service, in Revenue Ruling 73-395 (1973-2 C.B. 87), specifically rejected the book publishers' plea for equal treatment when it pronounced that "costs incurred in the writing, editing, design and art work directly attributable to the development of the textbooks and visual aids do not constitute research and experimental expenditures under Section 174."

3. In 1976 Congress enacted legislation (section 2119 of the 1976 Tax Reform Act) that blocked the IRS' efforts to deny these deductions. The effect of the 1976 legislation has been to allow book publishers to deduct, as current expenses, their editorial and similar costs incurred in the process of developing new books, thereby maintaining equality with other industries.

4. Based on a footnote in the 1986 Conference Report, the Treasury now takes the position that the 1986 Act, by implication, repealed the 1976 protective statute (section 2119). It further insists that costs of developing printed materials are automatically excluded from section 174 treatment, regardless of the character of the materials or the development process involved.

5. Treasury's interpretation of section 263A singles out and discriminates against the book publishing industry. For virtually all other industries, costs of developing new products can still be deducted currently as R&D costs under section 174. Book publishers, practically alone, would be denied these current deductions.

6. AAP submits that Treasury's position (embodied in its temporary and proposed regulations) is inconsistent with the terms of both the 1986 Act and the 1976 legislation, as well as grossly unfair and contrary to sensible national policies and priorities.

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R&D EXPENDITURES BY PUBLISHERS

The activities of a book publisher in preparing instructional, reference, or professional materials involve work that qualifies as "research or experimental" ("R&D") by any reasonable standard. We have submitted, for the information of the Committee, a detailed description of how a book publisher develops an elementary textbook system. Publishers of materials for use at other educational levels, as standard reference works, or for home-study or professional development follow similar procedures.

In general, the process begins with careful research into the need for a new or improved product, followed by preliminary testing and definition of pedagogical and substantive approaches and concepts. This phase features extensive review of the latest pedagogical data and analysis, as well as interacting with teachers, academics and school administrators. Thereafter, the publisher's staff, in collaboration with the author or team of authors selected to carry out the project, defines the general specifications for the product. Based on these specifications, the publisher and author team work together to create one or more prototypes of the new product.

These prototypes are then tested and evaluated by the publisher's staff, working in classroom settings with teachers and students and with experts in the field, to develop highly detailed specifications. These specifications function as blueprints for the authorship team in preparing the first full manuscript. The authors then prepare successive drafts, which are reviewed by the publisher's staff for conformity to the specifications, and subjected to further field testing and evaluations.

Throughout the process, the publisher is continually and closely involved in classroom testing and in expert evaluation to determine if the product will function properly in the intended educational setting. Based on this trial-and-error approach, the product is modified until a final version is ready to be prepared for printing and mass production. In some cases, particularly in the case of elementary and secondary school textbooks subject to a governmentally operated "adoption" procedure, the process of testing and modification continues even after the materials are initially prepared for printing and manufacture.

The process of developing instructional, reference, and professional material is characterized by heavy involvement of the publisher's staff, not merely in revising an author-submitted manuscript, but in conceptualizing the product, developing detailed plans, and working with potential users and substantive and instructional experts in testing and evaluating preliminary outlines and drafts. In response to these tests and evaluations, the product under development is continually modified and adjusted as the development process goes on.

In all instances, this preproduction development process for instructional, reference, and professional materials is not what is normally thought of as "editing." It is a radically more complex, sophisticated and intense process. It considers not only the order and organization of the words used, but the whole format for presenting the material, including the scope of the subject covered, the order of presenting subjects, the relation of graphics and illustrations to the educational objectives of the publication, and the effectiveness of particular methods of presenting the material. It embodies classroom field tests and expert evaluations of preliminary designs and prototypes that feed back into the process.

In many cases, the product resulting from these R&D efforts comprises several interrelated elements to be used in conjunction with each other. For example, in the case of elementary school instructional materials, the product developed by this process of research, experimentation and testing, with modifications based on results at earlier stages, is not a single textbook, but a whole system of teaching aids (such as filmstrips, overhead transparencies, demonstration materials, and computer software), teacher manuals and special teacher editions of the text, student workbooks, and testing materials.

The instructional publisher's systematic planning, testing, and evaluation throughout a product development process, feeding back into continual modifications of the emerging product to insure effective application of knowledge and techniques to a final product, is exactly analogous to the R&D process of other industries which apply technology and the results of experimentation to the development of new products.

There is no sound reason to deny publishers of instructional, reference, and professional materials the same tax treatment for R&D costs that manufacturers of other products enjoy. Indeed, the critical social importance of quality educational materials makes it especially appropriate to allow current deduction treatment in these cases.

LEGISLATIVE AND REGULATORY BACKGROUND

Since 1954--and, in practice, before that--costs of research and development of new products have generally been allowed as a current deduction under section 174, even if those costs would otherwise have to be capitalized. In 1986, Congress adhered to the consistent practice of favoring new product development by creating a major statutory exception to the new uniform capitalization rule--section 263A(c)(2), which specifically preserves the section 174 deduction for "research or experimental" expenditures ("R&D"). Consequently, most industries will gain significant relief by being able to continue to deduct costs of product R&D.

Barred from this relief, however, is the book publishing industry, which has been disqualified from using section 174 by the Treasury's erroneous reading of section 263A. As a result, book publishers will be subject to the full rigor of section 263A, even for R&D devoted to the creation of "intangible" assets in the form of copyrights--despite the fact that section 263A specifically applies to real property and only "tangible" personal property.

Treasury Regulations § 1.174-2(a)(1)

Section 174 was included in the 1954 Act as originally enacted to--in the words of the reports in both Houses of Congress--"encourage taxpayers to carry on research and experimentation." H.R. Rep. No. 1337, 83d Cong. 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong. 2d Sess. 33 (1954). Section 174 does not discriminate among different kinds of products, and there was no discussion of any such limitation when it was enacted.

At the outset, the regulations under section 174 interpret its scope very broadly to include "all ... costs incident to the development of ... a product." Treas. Reg. § 1.174-2(a)(1). In practice, the cases, published revenue rulings, and internal IRS pronouncements reflect this broad view and permit almost all industries to elect under section 174 to deduct their product development costs. In many cases, neither the products nor the process have the high degree of technical content manifested in the development of instructional, reference, and professional publications.

Treasury has, however, resisted application of section 174 deductions to <u>any</u> printed product, regardless of its character. Reg. § 1.174-2(a)(1) (originally adopted in 1957) has provided that "research or experimental expenditures" do not include "expenditures paid or incurred for research in connection with literary, historical, or similar projects." Although this could reasonably be read only as preventing amateur writers from attempting to deduct the costs of their "research hobbies," Treasury has read it as barring R&D treatment for any product embodied in print, even highly technical material or material developed on the basis of a process of analysis and experimentation that would clearly qualify as R&D in any other context.

The discrimination against book publishers is put into sharp focus when one recalls that in 1983 Treasury spokesmen recognized that R&D deductions are claimed by taxpayers in such varying business lines as fast food restaurants, baked goods, home building, banking, stock brokerage and the like. Even more startling, computer software products--commonly produced by book publishers, and marketed and inventoried side-by-side with books containing identical information--are given generous R&D deduction treatment by the IRS. It is anomalous to permit R&D deductions for one type of intellectual product while denying it to another similar product.[1]

<u>Revenue Ruling 73-395 and Congressional Criticism</u>

Prior to 1973, most book publishers followed their consistent practice (for book and tax purposes) of deducting preproduction editorial and similar costs without disruption by the IRS. In 1973, however, the Internal Revenue Service issued Rev. Rul. 73-395, 1973-2 C.B. 87, expressing the IRS position that preproduction editorial costs must be capitalized as part of the cost of the book copyright and are not deductible under section 174 on the ground that "costs incurred in the writing, editing, design and art work directly attributable to the development of the textbooks and visual aids do not constitute research and experimental expenditures under section 174."

This proposed treatment for the book publishing industry was strongly criticized as discriminatory and unjustified, and corrective legislation was introduced on a number of occasions. In 1974, for example, Congressman Dan Rostenkowski co-sponsored legislation to this end and, in doing so, referred back to the 1954 enactment of section 174, stating:

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1 In practice, more and more instructional, reference, and professional materials are appearing in both computer and print form, leading to the anomalous situation in which the costs of creating and developing a printed mathematics workbook, for example, are not eligible for the deduction, but the cost of developing a program for presenting the same information on a computer screen would be eligible.

"There is no suggestion in these reports that section 174 would not apply to the costs of research and experimentation necessary to develop products of book publishers, such as textbooks, reference books, visual aids, and other teaching aids, merely because the taxpayer's business is publishing or because the teaching aid or other product of a publisher is in the form of a printed book rather than in the form of a mechanical device. Section 174 should not be interpreted to discriminate against book publishers in the business of developing or in improving reference books, teaching aids or other products."

Further criticizing IRS' interpretation of the Reg. § 1.174-2(a)(1) disqualification of "research in connection with literary, historical, or similar projects," Mr. Rostenkowski urged that "this regulatory exclusion should be confined to its proper scope, for example, to preclude the amateur novelist from deducting his essentially personal expenses in the guise of business research expenses."

Section 2119 (Revenue Act of 1976)

In 1976, Congress responded to these criticisms of Treasury's position by enacting section 2119 of the Revenue Act of 1976 to block IRS' use of Revenue Ruling 73-395 and to allow publishers to continue to treat their editorial and other "prepublication expenditures" "in the manner ... applied consistently by the taxpayer to such expenditures before the date or issuance of such revenue ruling." Congress further cautioned IRS that any future regulations relating to this issue "shall apply only with respect to taxable years beginning after the date on which such regulations are issued."

No action has been taken by Treasury to date to comply with this Congressional direction. Consequently, the effect of the 1976 law was to maintain de facto parity between publishing and other industries.

This detailed and specific congressional directive concerning prepublication expenses of book publishers was never mentioned in the extensive legislative history of the uniform cost capitalization rules that became section 263A in the 1986 Act. No reference to section 2119 appears anywhere in the text or legislative history of the 1986 Tax Reform Act. No hearings were held on this issue, and no opportunity was given to the publishing industry to present its views.

Temporary and Proposed Section 263A Regulations

However, Treasury's temporary and proposed section 263A regulations now take the position that section 2119 of the 1976 Act was in essence repealed by section 263A, and that all book publisher's product development costs must be capitalized under section 263A and cannot be deducted under section 174. This position is inconsistent both with the 1986 legislation and with basic principles of statutory construction.

Repeal by implication, says the classic maxim of statutory interpretation, is generally disfavored. Further, as a matter of substance, a very general later law should not be viewed as repealing a highly specific earlier one.

Even if section 263A did override the 1976 provision, capitalization of the publishers' costs at issue is not necessarily required. For section 263A states that the new rules apply only to real property and "tangible" personal property. In turn, the latter term is statutorily defined as including "a film, sound recording, video tape, book, or similar property." As to the book publishing industry, this would appear to mean the costs of the actual tangible product--platemaking, printing, as well as other production costs.

1986 Conference Report

The Conference Report repeats that "application of the uniform capitalization rules with respect to production activities is limited to tangible property." But in a last-minute footnote added to Conference Report (II-308), the term "tangible property" is broadly expanded to include a number of intangible items:

> " ... films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book."

Despite this murky 1986 legislative background, the proposed section 263A regulations elevate the Conference Report footnote to a statutory level. They declare that section 263A, as a new Code section, is not included within the coverage of section 2119 and that, in any case, section 263A repeals section 2119. They do so by denying section 174 treatment for, and flatly requiring capitalization of, "prepublication expenditures incurred by publishers of books and other similar property, including payments made to authors of literary works, as well as costs incurred by such publishers in the writing, editing, compiling, illustrating, designing and development of books or similar property."

This Treasury position may aptly be described as legislation by footnote.

In light of the strained regulatory position taken by the Treasury--over the strong objections of the industry and expressions of concern by many members of Congress--on the meaning of section 263A, the only feasible solution for book publishers is to seek corrective legislation, to clarify that section 174 provides them with equivalent product development deductions comparable to those given to other businesses.

PROPOSED CORRECTION

The AAP urges that the appropriate resolution of this issue is to afford publishers of instructional, reference, and professional materials the same treatment for their R&D costs as is afforded other businesses. Such action would be fully consistent with the terms and purposes of the 1986 Act and would prevent the severe adverse impacts that would flow from Treasury's misreading of the 1986 Act as applied to publishers' R&D costs.

Request for Parallel Tax Treatment

The book publishing industry is not asking for special treatment, but only for equal treatment with other industries.

Under the correction we propose, section 174 would explicitly be declared applicable to research and development expenditures of a publisher of "instructional materials." Qualification as "instructional materials" would be expressly limited to materials prepared for publication with the principal purpose of use in systematic instructional activities in elementary, secondary, or vocational schools, or in post-secondary schools; as reference works or technical materials for use by persons in the conduct of their professions; or as instructional reference works, i.e, materials published for self-instructional activities in the liberal arts, the sciences, or similar disciplines and standard reference works such as encyclopedias, dictionaries, and thesauruses. Publications not coming within these definitions of "instructional materials" would not be covered.

Further, even for the limited category of publications covered, only those prepublication costs that qualify as R&D costs would be eligible. As explained above, for the publishing industry, those qualifying costs are the costs of identifying the need for a new or improved product, of gathering laboratory data related to it, of conceptualizing the product, of developing and field testing prototypes, of developing the manuscript, of designing and field testing the final layouts, of making content and design changes as a result of such field testing, and of pilot testing and adoption procedures. Not within the purview of section 174, but instead subject to capitalization, would be the following: Advance royalty payments to authors and costs of actual manufacture of the books or other products, including platemaking costs (material, typesetting, film making and labor), as well as production costs (paper, ink, binding, jackets and labor).

In sum, this committee's adoption of the proposed amendment would:

-- Correct an improper interpretation of the 1986 Act,

-- Eliminate the unjustified discrimination produced by Treasury's interpretation,

-- Foster innovation and creativity by educational book publishers,

-- Support their efforts to improve and modernize teaching, reference, and professional materials, and

-- Serve the public interest by strengthening sensible national educational policies and priorities.

Association of American Publishers

Washington, D.C.
July 22, 1987

EXHIBIT TO

STATEMENT OF ASSOCIATION OF AMERICAN PUBLISHERS, INC.

PUBLISHING AN ELEMENTARY SCHOOL TEXTBOOK SYSTEM

The publishing of educational materials for elementary schools is a complex process that involves extensive planning and research, and usually requires three and one-half to eight years to complete from inception to final product. The final product is not simply a textbook. The final product is an entire instructional system that consists of teaching aids (such as film strips, overhead transparencies, and computer software), as well as the pupil and teacher editions of textbooks, testing materials, etc. The educational textbook system will provide instructional materials for teaching a particular subject in each of the grade levels in which the subject is taught in elementary school. Some programs, such as mathematics and reading, which are taught from kindergarten through grade 6 or 8, may consist of as many as 200-300 components, all of which must be developed simultaneously.

The educational publisher is the creative force in the development of each new textbook system. The publisher researches the need for a new product, and researches, tests, and develops the pedagogical and philosophical concepts of the new product. The publisher, in collaboration with a team of authors selected by the publisher, creates the general specifications for the entire system including all the elements mentioned above. Based on these specifications, the publisher and authorship team will create one or more prototypes of the various components of the new system. Through extensive testing and evaluation of these prototypes, the publisher will develop detailed specifications for the new system, which will serve as a blueprint for the authorship team in writing the first full manuscript. Throughout the process of developing the manuscript and the other components of the educational textbook system, the publisher is continually involved in field testing the various components of the system to determine if the product will function in a classroom setting and meet the demands of the educational marketplace. This stage of the editorial process also involves, for example, developing appropriate illustrations, charts, graphs, etc. for inclusion in the textbook or other components. It is this involvement in the process of testing and development, involving sizable editorial and research staff, that makes the educational publisher unique in the publishing industry.

To help you understand the complexity of educational publishing more fully, the following overview of the developmental and production stages of elementary textbook publishing is presented.

1. Identify Need for Product (6 to 12 months)

The development of an elementary textbook system typically begins when a publisher recognizes the potential need for a new product in the educational marketplace. Sometimes this happens when, for example, a state announces that it will buy elementary mathematics books in 1991. Sometimes the idea of a potential need for a new product may come to a publisher as a result of the publisher's study of trends in education. The need for a new educational textbook system may arise as a result of new developments in the subject matter, in teaching techniques or theories, or in instructional technology. For example, based on discussions with a few key educators, the publisher may decide there could be a need for a new spelling series.

Based on the idea that there could be a need for a new product, the publisher will engage in extensive research that enables the publisher to understand the market more clearly. This research includes a detailed study of issues and trends, involving professional and scientific seminars and symposia, as well as constant review of current literature. The publisher will survey teachers and other education professionals to help identify pedagogical needs in the subject area. The publisher will seek to determine what educational materials and teaching techniques are currently being used, what aspects of the base curriculum are being emphasized or should be emphasized in a new product, and what types of systems have been utilized in the past (e.g., video tapes and computer programs). The entire fact-gathering process concludes with careful analysis of the data. At this point the publisher targets a potential market. It might be determined, for example, that there is, in fact, a need for a new spelling series. On the other hand, the preliminary research step might indicate that the market for such a series is too small to be profitable.

2. Gather Laboratory Data (9 to 12 months)

To an educational publisher, the laboratory in which products are tested is the same place in which the products will eventually be used--the classroom. It is to this laboratory that the publisher first turns to begin to develop the concept of a new product.

Educators at all levels--from the college researcher to the superintendent and classroom teacher--are consulted to find out about specific requirements for the product. For example, should word problems be included in each grade of the mathematics series? Should the reading program be phonics-based or vocabulary-based? How much of a science program should include science experiments? To what extent should map skills be taught in a social studies program? In what way should writing be taught in an English program? How should students' mastery of a particular subject or skill be tested and evaluated?

These educators are also consulted about the various forms that different components should take. For example, a given system usually includes ancillary printed materials, such as workbooks, in addition to software, video tapes, records, and filmstrips. The use of new forms of technology, such as videodiscs, is also explored.

Further information is gleaned from meetings with focus groups, which are made up of approximately twelve to fifteen educators. In these focus group meetings, the publisher is able to have a face-to-face discussion with educators in different parts of the country and in different teaching situations. The educators are often given opportunities to react to some of the publisher's preliminary plans.

Classroom visits, in which the publisher observes lessons being taught in the classroom, enable the publisher to observe first-hand how subjects are actually being taught in the classroom. These observations help the publisher learn how the most current teaching philosophies are actually implemented in the real world. Follow-up discussions with the teacher allow the publisher to find out about the teacher's pedagogical concerns and to obtain reactions to more of the preliminary project plans. Discipline specialists are consulted to help complete the picture of the needs of the market and the feasibility of a new product.

3. Conceptualize Product (6 to 12 months)

It is at this point that the concept of a new textbook system begins to crystallize. The publisher takes the information that has been gathered concerning the size and description of the market, the pedagogical needs of the customers, and the latest research, and makes a preliminary decision whether to proceed with the project. This decision is usually made by a "publishing council," made up of key publishing house executives. If it is decided there is no need for a new product, or if it is decided there is not a profitable market for a new product, the project ends here. If it is determined that more information is needed before a decision can be made, more research is requested. If it is decided to continue the project, work begins on the process of developing the specific philosophy and framework of the new system.

During the period of preliminary research and concept development, an author search begins. The publisher looks for educators who specialize in a particular field to become author candidates. As part of the search, candidates are usually asked to submit writing samples and to participate in an interview with the editorial team. By the time preliminary approval of the project is granted by the publishing council, this search is nearly completed.

Unlike other types of authors, textbook authors are approached by the publisher. Customarily, the team of authors assigned to a project divides a royalty of approximately 5 percent. This low royalty rate reflects the major role the publisher plays in the creation of a system. It is the textbook publisher, not the author, who performs most of the research for, and development of, an educational textbook system. Typically, royalty advances are made to the authorship team only to the extent needed to cover their out-of-pocket expenses for the project (including, for example, amounts to cover salaries lost because an author must take a leave of absence to work on the project).

4. <u>Develop and Field-Test Prototype</u> (6 to 12 months)

Together with the authorship team, the publishing house editorial team begins to develop the general outline of the new system, called the "scope and sequence." The "scope" of the system defines the boundaries of the subject area to be covered. The "sequence" of the system defines the order in which the various parts of the subject area will be presented in the new system. The sequence will reflect the pedagogical plan developed by the publisher, incorporating, for example, the method and order in which new skills will be introduced to the students in successive grade levels. Developing the scope and sequence will even involve determining the number of chapters that will be in each textbook in the series, the subject matter of each chapter, and the number of pages each chapter should contain. Input from the market and additional research are used to constantly modify the scope and sequence until, finally, there is agreement that it meets the needs of the market and is pedagogically sound.

Prototypes of key components of the system are written, based on this scope and sequence. The prototype materials are reviewed by educators, both those hired as consultants and those who participate in focus groups. Samples of these prototype materials--lessons, investigations, activities, and parts of chapters or units--are duplicated in suitable formats for testing in the laboratory, the classrooms across the country. The samples are provided to selected schools, and with the guidance of editors and researchers, the teachers and students use the sample materials in a classroom setting to evaluate how well each of the components, and the system as a whole, work. Throughout this careful field-testing and evaluation procedure, the materials may be rewritten or reformatted a number of times before teachers and students can experience success with them. Sometimes two different models, for example two different versions of the same chapter, are tested to see which one is better. Data are continually gathered and analyzed during this trial-and-error period, and the field testing continues until the publisher is fully satisfied that the sample materials have been proved successful for classroom use.

Only when all of these tasks have been satisfactorily completed will the publishing council approve the development and field-testing of the complete system in a format resembling the final product. If these tasks have not been satisfactorily accomplished, one of two things will occur. The system either will be terminated at this point or the prototype materials will be modified and tested further. One instance of a major modification to a prototype system occurred with a new elementary school mathematics program. This system was begun in the late 1970s. In 1984 the publisher decided to make major changes to the system because the teaching philosophy in this subject area had begun to change in the early 1980s. As a result, an additional two years of development and testing was required to complete the system.

5. Develop Manuscript (15 to 24 months)

After the prototype materials have been successfully tested, detailed outlines, developed by the publisher and based on educational objectives, are provided to the authorship team to begin writing the first full manuscript as it might appear in the final product. This manuscript is edited and duplicated in a format that will resemble the finished textbook series. Often, the manuscript will be printed in the form of a photocopy or typeset copy of the text without color illustrations or other graphics that would appear in the finished product. This manuscript is then sent out for field testing and for review by consultants. In many subject areas, two types of consultants are used--those that specialize in the given subject, for example a biologist, and classroom teachers.

For field testing, a network of at least ten schools is established across the country. These sites always contain urban, suburban, and rural schools with student populations of various ability levels and socioeconomic and ethnic backgrounds. The entire manuscript is field-tested at this time; it may take from six months to a complete school year.

During the field testing, the trial-and-error process continues. Data are constantly gathered by observations, interviews, questionnaires, and tests. Teachers are interviewed and solicited for ideas on how to improve the materials. Students are interviewed, questioned, and tested. Editors and researchers analyze the data and also look for ways to improve the materials.

By the time the field testing is completed, much of the instructional material has been rewritten and is now proved effective for use by students. Often, field testing continues even after the system is being published in final form. Changes resulting from field testing may even occur between the first and second printings of a textbook series.

Some of the time frames given for each developmental phase will overlap, of course, but between three and one-half and six years will have passed from the time of the project's inception until the time the publisher feels that the product being developed is one that is pedagogically sound and one that will meet the needs of students and teachers around the nation. It will take still another one to two years to go through the editorial process and manufacturing phases.

6. <u>Editorial Process</u> (9 to 18 months)

This phase begins as manuscripts are finally completed. It is the stage where the creativity of the authors and editors is interpreted visually--with type, photographs, illustrations, tables, charts, graphs, and other graphic elements. The final manuscript of the textbook is reviewed by copy-editors for proper grammar, punctuation, syntax and paragraph structure. The manuscript will then be sent to a compositor (usually an outside vendor), who produces a running galley (<u>i.e.</u>, a galley without page breaks) that incorporates the type-size, the type of print, column width, and other type-design specifications. This galley is produced by computerized typographics. Copy-editors proofread the galley for errors. The editor, together with a designer, will then determine which parts of the text will be accompanied by graphics such as illustrations, photographs, charts, maps, etc. The designer "lays out" the pages <u>i.e.</u>, breaks the galley into pages that are laid out in the format of two facing pages and determines where the print and the illustrations should be located on each two-page spread. The designer will incorporate graphics into the galley, usually by pencil sketches. The result is a design of how each two-page spread will look to the reader as each page is turned. The editor reviews the design to insure that the design optimizes the presentation of the subject area. For example, an individual reading lesson or problem-solving lesson should be presented on a single two-page spread if possible.

Once the size of each illustration is determined, an artist (usually an outside vendor) will produce the illustration to fit the page. If photographs are to be included, a photo-research team (either in-house or outside vendor) will obtain photographs from various sources from which an appropriate photograph can be selected. Because visual elements often are important to understanding, evidence gathered from the laboratory and field testing is used when final design decisions are made. For example, careful selection of a photograph may clarify an idea that is difficult to describe in words alone; or color may be used to highlight sections of a pupil edition or teacher edition to improve reading ease, understanding, and enjoyment.

After the "lay out" is complete, the compositor will produce a page galley that shows the printed text in the format determined by the designer. The editor at this point will do only fine-tuning to the text. At this stage, also, the product may be field tested again.

After illustrations, photographs, and other graphics have been selected and incorporated into the text, and the color, size, and format of the printed text has been determined, layouts and dummies of the final design must be prepared in order to convey to printers the information they need to print the books and other materials that reproduce the plans as the authors, editors, and designers intended. Dummies may also be used for further field testing.

7. <u>Production and Manufacturing</u> (3 to 6 months)

The compositor produces film of the printed text in final format. A proof of the film is sent to the publisher. This film proof stage is the last stage before the product goes to the printer in which the publisher has an opportunity to look at the composition of the print. Changes can be made in the film proof, although they are more expensive than changes at earlier stages.

In addition, the publisher will send the four-color artwork, photographs, and other graphics it has developed for the product to a "color separator," also typically an outside vendor. The color separator produces a "color separation" for each graphic, which means that the colors of the graphic are "separated" into four colors and each of the four colors is captured on a separate film negative. When the four color negatives are superimposed on each other they create a color negative that can be developed to reproduce all the colors in the graphic.

The publisher sends the final film negative and color separations to the printer. The printer then produces a plate from each film negative for each different color through an impression process, and these plates are used to print all the colors on each page. The final product is created when the pages are printed and bound as books.

When the new textbook series finally rolls off the press, it is a thoroughly comprehensive system, with student texts, teacher editions, and an extensive array of ancillary materials. Ancillaries may include workbooks, laboratory manuals, a variety of duplicating masters (i.e., materials that the instructor can photocopy) tests, posters, outline maps, color transparencies, equipment packages, filmstrips, video tapes, phonograph records, computer software, and so on, all of which the publisher will have developed and tested before the production phase. The system will meet all the needs of the most critical and demanding educators.

8. Pilot Testing and the "Adoption" Process (6 to 12 months)

After a new textbook system has been published, testing of the system does not stop. Samples of the system are extensively pilot-tested in schools located in different parts of the United States. The "pilot" schools selected for testing the published edition are selected to insure the edition is used by a full cross-section of the student population.

Providing these samples of the published edition may help sell the product to a school system. Some school systems in the market for a new textbook system will request samples from several publishing houses for testing in different schools within their system. This testing program also helps the publisher verify that the educational textbook system works and provides feedback that is used to revise and perfect later editions.

In addition to continued testing and marketing of the published edition, educational publishing houses must deal with the "adoption" process in approximately half of the 50 states. These "adoption" states do not permit the sale of textbook systems within their school districts until the program has been reviewed by the state and "adopted." Very often the results of all the field testing of a new textbook system, including field tests of the published edition, are provided to the state education department in order to demonstrate the effectiveness of the new system. In some cases, the system must be pilot-tested in several schools within the state's school system. The states also review the system to insure it meets the state's requirements concerning subject content and pedagogical approach. In some states, there is public participation in the adoption process, raising issues concerning the social or value content of the textbook system. Revisions to an edition to meet state adoption requirements are generally incorporated into the edition that is sold nationally, although a publishing house may decide that the peculiar requirements of a very populous state justify a special edition to be sold only in that state. Revisions to a published edition may be minor and straightforward, or may involve changes that require further testing to verify that the revised edition accomplishes the desired goals.

COMMENTS BY ASSOCIATED FINANCIAL CORPORATION

ON

TECHNICAL CORRECTIONS ACT OF 1987

Amendments Related to Section 252 of the Reform Act
(H.R. 2636, S. 1350)

BACKGROUND STATEMENT

This paper proposes technical corrections and substantive amendments to section 42 and related provisions of the Internal Revenue Code of 1986 (the "Code") dealing with the low-income housing credit. The low-income housing credit, which was enacted as part of the Tax Reform Act of 1986, was designed to replace the multiple tax preferences for investment in low-income housing that existed under prior law. Congress believed that the credit was a more efficient mechanism for encouraging private sector investment in low-income housing projects.*

Unfortunately, a variety of problems with the original statute have arisen, many of which will be alleviated if the recently introduced technical corrections bill (H.R. 2636; S. 1350) is enacted in its present form. Particularly noteworthy in this regard are those provisions of the bill which:

- Waive the "secured by the . . . building" requirement of section 42(k)(2)(B) for otherwise qualifying debt in situations where a security interest in the building is not allowed by the Federal agency holding or insuring the first mortgage and the "proceeds" from the unsecured financing are applied to acquire or improve the building (although this provision should be amended to confirm that it applies to purchase money and other acquisition indebtedness).

- Allow taxpayers to elect to determine the credit amount, based on interest rates existing at the time of investment, before the building is placed in service.

- Allow projects to be eligible for credits allocated in the previous year if the project was delayed "for reasons unforeseen and beyond the control of the taxpayer."

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* For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1413; S. Rep. No. 99-313, pp 757-768; Senate Floor Amendment, 132 Cong. Rec. S8146-8158 (June 23, 1986); and H. Rep. No. 99-841, Vol. II (Sept. 18, 1986), pp. 85-103 (Conference Report).

- Provide exceptions, mainly in cases of foreclosures and acquisitions by government and qualified nonprofit entities, to the general rule that buildings are not eligible for the credit if they had previously been placed in service within ten years of the acquisition date.

- Make partnerships, rather than individual partners, subject to the recapture of credits so long as 50% or more of the partnership is owned by at least 35 natural persons or estates.

While we endorse and recommend the adoption of the foregoing provisions, the technical corrections bill still fails to address several significant statutory deficiencies which, to date, have inhibited the effective implementation of the credit program. The proposals recommended below seek to remedy these statutory deficiencies with the desired goal of making the credit program more workable administratively, thus ensuring that it will achieve its intended purpose of providing decent and affordable housing to low and moderate income families.

PROPOSED STATUTORY AMENDMENTS AND REASONS THEREFOR

I. Section 708(b)(1)(B) Terminations

A. Statutory Change. To treat purchases of partnership interests that cause section 708(b)(1)(B) terminations as purchases of the underlying assets--

Subsection (d) of section 42 is amended by adding to the end thereof the following paragraph:

(8) Certain Purchases of Partnership Interests.--

(A) In General.--For purposes of determining the eligible basis of an existing building, the purchase by a person or persons, in a single transaction or a set of interdependent transactions, of the capital and profits interest of a section 42 partnership sufficient to cause a termination of such partnership pursuant to section 708(b)(1)(B) shall be treated under this section as a purchase by such partnership of the assets held by such partnership.

(B) Application of Paragraph (2)(B).--In the event of a transaction or set of transactions described in subparagraph (A), the following will apply in determining whether the requirements of paragraph (2)(B) of this subsection have been met--

(i) Section 179(d)(2).--For purposes of applying section 179(d)(2)(A) and (C), the person or persons acquiring the interest in the section 42 partnership shall be treated as the person acquiring the property and the person or persons from whom the interest in the section 42 partnership is acquired shall be treated as the person from whom the property is acquired.

(ii) Previously Placed in Service.--For purposes of applying paragraph (2)(B)(ii) and (iii), the person or persons acquiring the interest in the section 42 partnership shall be treated as the taxpayer.

(C) Limitation.--This paragraph shall only apply to that portion of the acquisition cost attributable to the purchase described in subparagraph (A) incurred by, and the benefits of this section shall only be allocated to, those persons who purchased an interest in the section 42 partnership in a transaction described in subparagraph (A) and whose relationship to the person or persons from whom such interest is acquired is not described in section 179(d)(2)(A) (as modified by paragraph (2)(D)(iii)(I) of this subsection).

(D) Section 42 Partnership.--The term "section 42 partnership" refers to any partnership if, at the time of its termination under section 708(b)(1)(B), 80% or more of the gross value of its assets consist of--

(i) a building or buildings consisting of residential rental units,

(ii) money and other property (including land) incidental to the operation of the building or buildings described in clause (i), and

(iii) investments in a section 42 partnership or partnerships (held directly or indirectly through a tiered partnership arrangement).

B. Reason For Change. Section 901 of the Housing and Urban Development Act of 1968, 82 Stat. 476, 507 (the "1968 Act"), declares "that it is the policy of the United States to encourage the widest possible participation of private enterprise in the provision of housing for low or moderate income families." To accomplish this task, the 1968 Act contemplated the formation of partnerships as the preferred vehicle for facilitating private sector investment in housing projects. See S. Rep. No. 1123, 90th Cong., 2d Sess. 85 (1968). See also 114 Cong. Rec. 14946, 15136 and 15241 (1968). While Congress was cognizant of this fact when it enacted the low-income housing credit provisions,* it failed to provide adequate guidance as to the application of the credit in situations where investments are made through partnerships or other flow-through entities.

In acquiring an interest in a low-income housing building, there are oftentimes legitimate, non-tax reasons for purchasing partnership interests rather than acquiring a direct interest in the building itself. For example, a direct transfer of the building may invoke a due-on-sale provision under an existing mortgage or otherwise be barred by contractual provisions requiring the consent of an adverse partner often owning rights to only a small portion of the building. In such cases, the investor would typically purchase a majority position in the partnership, thus resulting in a constructive termination of the partnership under Code section 708(b)(1)(B).

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* See, e.g., Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, p.154, n.3.

Upon a section 708(b)(1)(B) termination, the partnership is viewed as having made a constructive liquidating distribution of its assets to the partners (including the new investor), followed immediately thereafter by a constructive contribution of the same assets back to the partnership. This mechanized view of the transaction permits the investor to obtain a basis in his share of the partnership's assets equal to the tax basis of his newly acquired partnership interests. It is clear that the intent behind a section 708(b)(1)(B) termination is to treat the purchase of a majority interest in a partnership as tantamount to a direct purchase of a proportional interest in its assets. See, e.g., McCaulsen v. Commissioner, 45 T.C. 588 (1966).

The current operation of Code section 42(d) casts serious doubts as to whether the credit is available in situations where the acquisition involves the purchase of a controlling partnership interest. For instance, the following questions are raised by such a transaction:

a. Whether the "purchase" requirement of section 42(d)(2)(B)(i) is satisfied insofar as section 179(d)(2)(A) excludes from the definition of "purchase" acquisitions from a person who owns a 10 percent or greater interest in the acquiring partnership and this requirement would be technically violated upon the partners' deemed contribution of the building back to the partnership upon its constructive termination.

b. Whether the prohibition against acquisitions from related parties contained in section 42(d)(2)(B)(iii) will be contravened since both the partnership and its partners may be considered related at the time of the partnership's constructive liquidation (i.e., the theoretical time in which the building is placed in service by the partners).

c. Whether the building would be placed in service by the partners (i.e., upon the constructive liquidation of the partnership) within the last ten years, thus running afoul of the requirement in section 42(d)(2)(B)(ii).

The proposed statutory changes would remove these uncertainties, thus enabling investments in qualifying projects to be made by way of a partnership acquisition. The benefits to be derived from such an acquisition would be allocated solely to the purchasing entity rather than the existing partners. This would alleviate what, for many existing projects, has been a significant impediment to the attraction of badly needed capital.

II. "Purchase" Requirement Determined at Time Building Placed in Service

A. Statutory Change. To clarify that the determination of whether a "purchase" has occurred should take place at the time the building is acquired for purposes of claiming the credit--

> Subclause (I) of section 42(d)(2)(D)(iii) is amended by inserting before the period "and the determination under section 179(d)(2)(A) shall be made at the time the building is acquired by the taxpayer."

B. Reason For Change. For purposes of determining whether a low-income building was acquired from a "related person," section 42(d)(2)(D)(iii) should be amended to make it clear that the 10% ownership rule is to be applied at the time the building is acquired. As the statute now reads, it is possible to interpret the 10% rule as applying at any time during the 15-year compliance period. Such a construction would create investor uncertainty as to whether previously allocated credits will be recaptured upon the acquisition by a "related person" (through inadvertance or otherwise) of an impermissible interest in an investment entity. This uncertainty, in turn, could impact negatively on the investor's willingness to participate in a low-income housing program.

III. At-Risk Rules

A(1) Statutory Change. To provide for consistency between basis for section 42 and section 465 purposes--

Paragraph (6) of section 465(b) is amended by adding to the end thereof the following new subparagraph:

> (F) Qualified Nonprofit Organizations.--To the extent nonrecourse financing from a "qualified nonprofit organization" (as defined in section 42(h)(5)(C)) is taken into account in computing the qualified basis (as defined in section 42(c)(1)) of a low-income building pursuant to the provisions of section 42(k)(2)(A), such financing shall be treated under this section as qualified nonrecourse financing.

B(1) Reason For Change. The at-risk rules, which were extended to the activity of holding real property by the Tax Reform Act of 1986, generally preclude an investor from deducting losses which exceed his at-risk investment in the activity giving rise to the loss. These rules also limit the amount of low-income housing credits that may be claimed with respect to projects financed in whole or in part with nonrecourse debt. Unfortunately, the rules do not work in tandem with respect to seller financing that is provided by certain nonprofit organizations whose exempt purpose includes the "fostering of low income housing." Such financing is included in basis for credit purposes under section 42, but not for loss limitation purposes under section 465.

This statutory dichotomy is apparently inadvertant insofar as there is no logical support or policy justification for the distinction. The proposed amendment cures this inconsistency by harmonizing the two basis rules, thereby permitting indebtedness qualifying under the seller financing exception to be includible in basis for both loss limitation and credit purposes.

A(2) Statutory Change. To provide that holding an investment in a partnership which owns real property constitutes the holding of real property--

Subparagraph (E) of section 465(b)(6) is amended by adding at the end thereof the following new clause:

> (iii) Holding Interests in Certain Partnerships.--Holding an interest in a partnership shall constitute the activity of holding real property, provided that at least 80 percent of the gross value of the assets of such partnership consists of real property.

B(2) Reason For Change. The proposed amendment constitutes a long-overdue codification of an informal rule which is implicit in the legislative history of the Revenue Act of 1978 and which has been followed by the IRS and most practitioners.

A(3) Statutory Change. To provide that a security interest in a partnership interest will be treated as a security interest in the qualified low-income building--

Subparagraph (B) of section 42(k)(2), as amended by S. 1350 and H.R. 2636, taking into account paragraph (8) of section 42(d) as added above, is amended by adding a new sentence at the end thereof to read as follows:

> In the event of a transaction described in paragraph (8)(A), a security interest in the section 42 partnership interest shall be treated as a security interest in the building.

B(3) Reason For Change. Government financing agencies, particularly HUD, typically will not allow a junior lien to be placed on a building which is encumbered by a mortgage which the agency holds or insures. As discussed above, the technical corrections bill recognizes this fact and purports to waive the "secured by the building" requirement of section 42(k)(2)(B) in situations where the proceeds from the financing are applied to acquire or improve the building. While we endorse this amendment, we believe the at-risk rules should be broadened to include purchase money indebtedness incurred to acquire interests in partnerships owning existing low-income housing projects. The business necessities and rationale supporting this provision are discussed in I. B. above in connection with the treatment of the acquisition of partnership interests.

IV. Credit Recapture

A(1) Statutory Change. To provide more certainty as to the allocation of credit recapture among partners of large partnerships--

> Clause (iv) of section 42(j)(5)(A) is amended by striking "as such partnership's taxable income for such year is allocated among such partners" and inserting in lieu thereof "as the tax credits giving rise to such increase in tax were allocated among the partners or their predecessors in interest."

B(1) Reason for Change. The proposed amendment provides for a more rational and logical method of allocating credit recapture among partners of large partnerships, i.e., in the manner in which they previously benefitted from the credits giving rise to the recapture. The current provision is inadequate for various reasons, not the least of which is the partnership may never generate taxable income. In addition, the allocation of taxable income may bear little relationship to the method of allocating depreciation deductions, which in turn governs the allocation of tax credits under the existing section 704(b) regulations.

A(2) Statutory Change. To provide recapture rules with respect to dispositions of partial interests in partnerships other than those described in section 42(j)(5)(B)--

Paragraph (5) of section 42(j) is amended by adding to the end thereof the following subparagraph:

> (D) Treatment of Other Partnerships.--In the event a partnership does not comply with clauses (i) and (ii) of subparagraph (B), the disposition by a partner of a partnership interest shall result in recapture of the credit recapture amount attributable to the interest disposed of under the principles adopted by section 47 and the regulations thereunder.

B(2) Reason For Change. The recapture rules set forth in Section 42(j) provide no guidance as to the consequences of a partial disposition of a partnership interest where the partnership is not described in section 42(j)(5)(B). There is also a question as to whether fluctuations in a partner's share of the partnership's income may result in recapture and a permanent loss of otherwise available credits. The absence of any guidance in this regard produces investor uncertainty and may discourage investment in low-income housing projects.

There is, however, already in place a mechanism whereby dispositions of partnership interests are analyzed in order to determine whether the investment credit recapture rules should apply. This mechanism is set forth in Treasury Regulations section 1.47-6, and provides generally that a partner is required to recapture investment tax credits, on a proportional basis, when the partner's interest is reduced below 66-2/3 percent of that partner's interest in the partnership as it existed on the date the property was placed in service. Section 42 should be amended to incorporate these rules (with appropriate modification for factors unique to the low-income housing credit), thereby lending definition to what is now a muddled area.

V. Waiver of 10-Year Requirement

A. Statutory Change. To provide that HUD may waive the 10-year requirement of section 42(d)(2)(B)(ii)--

Subparagraph (A) of section 42(d)(6) is amended by inserting the phrase "or and appropriate official from the Department of Housing and Urban Development" after the phrase "(after consultation with the appropriate Federal official)", and by inserting "or such official from the Department of Housing and Urban development" before the word "determines", and by amending subparagraph (iii) thereof in its entirety to read as follows:

(iii) "by reason of other circumstances of financial or physical distress which adversely impacts upon the supply or quality of existing low-income housing."

B. Reasons For Change. As section 42 now reads, the Secretary of the Treasury has the sole authority (subject to a consultation requirement) to waive the 10-year requirement. In order to correct what may have been an oversight, the amendment provides that the authority for waiver of the 10-year requirement is extended to HUD, the agency most likely to be familiar with the facts and circumstances warranting the waiver. The conditions for the waiver essentially relate to situations in which the property is in financial or physical distress and any inhibition to the property's transfer could result either in a drain on the financial resources of HUD or the Federal mortgage insurance fund, or in a depletion in the stock of low-income housing. These are basically housing issues (not Treasury issues) as to which HUD is best equipped to decide.

VI. Certification Standard - 60%/60% Requirement

A. Statutory Change. To provide for a more workable administrative standard for certifying to the Secretary that applicable income test has been met--

Paragraph (1) of section 42(g) is amended in its entirety to read as follows:

(1) In General--The term "qualified low-income housing project" means any project for residential rental property if 60 percent or more of the residential rental units in such project at the end of the taxable year are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income. For purposes of this paragraph, any property shall not be treated as failing to be residential rental property merely because part of the building in which such property is located is used for purposes other than residential rental purposes. [Conforming changes would also be made to other provisions of section 42 affected by this amendment.]

B. Reason For Change. As Code sections 42(g)(4) and 142(d) now read, the owner of a low-income building is required to file annual certifications with the Secretary, establishing that either the 20-50 or 40-60 tests have been met. These rules apply for purposes of determining whether the building qualifies as a low-income housing project and whether any unit in the building is a low-income unit. The determinations must be made on a continuing basis, both with regard to the tenant's income and the qualifying area income (rather than only on the date the tenant initially occupies the unit).

The foregoing unit-by-unit analysis is endlessly complex and creates a labyrinth of paperwork which ultimately results in a huge divergence of time and energy away from the task at hand, namely, the refurbishment and rehabilitation of the available housing stock. Further, by requiring that the credit be tied to a specific percentage of the low-income housing units, which percentage may fluctuate downward--thus causing recapture--depending on such variables as tenant income and turnover, investors are uncertain as to the amount of credits that any particular investment will produce. In other words, investors may be unwilling to invest in a low-income housing project if minor changes in the income status of renters have the possibility of affecting the actual amount of credit allowable.

It suffices to say that the ends do not justify the means. Where a taxpayer can certify that 60 percent of a building's units satisfy the 60 percent income test, there is little likelihood that there are a significant number of units in the building held for rent to persons other than those who meet the income tests. Therefore, section 42 should provide a threshold certification requirement: If 60 percent of the building is either rented or irrevocably held out for rent to individuals meeting the 60 percent income test, all units in the low-income building should be deemed to qualify as low-income units; conversely, if the building fails to meet such threshold, no portion of the building should qualify for the credit. By applying a "bright-line" test, investors will have greater certainty as to the amount of credits they will receive, and such certainty will impact favorably on their willingness to commit investment dollars to programs which, by their very nature, are totally dependent on tax incentives. Further, rather than being ensnarled in the mounds of red tape and the ensuing bureaucracy spawned by the current certification provisions, the project operators and housing agencies can more efficiently devote their time and energy to the needs of the tenants.

VII. Limitations on High-Income Taxpayers

A(1) Statutory Change. To permit an investor to offset any alternative minimum tax liability with the allowable low-income housing credits--

(i) Paragraph (1) of section 38(c) is amended by deleting the word "The" and by adding in lieu thereof "Except as provided in paragraph (4)(E), the"; and

(ii) Paragraph (4) of section 38(c) is amended by adding at the end thereof the following new subparagraph:

(E) Special Rule for Low-Income Housing Credit.--If after the application of the credits allowed under paragraphs (1) and (2) the taxpayer's unused credits consist at least in part of the credit described in subsection (b)(5) (assuming that the credits described in subsections (b)(1) through (b)(4) are applied first), then

(i) the amount allowable under paragraph (1) shall be increased by the unused portion of such credit to the extent of the taxpayer's tentative minimum tax (as described in section 55(b)) for the taxable year, and

(ii) the amount allowable under paragraph (2) shall be increased by the unused portion of such credit to the extent of the amount described in section 55(a).

Any unused credit shall retain its separate character for purposes of the carryforward provisions set forth in section 39.

A(2) Statutory Change. To eliminate the phase-out of the $25,000 allowance applicable to the utilization of the low-income housing credit against non-passive income--

Subparagraph (B) of section 469(i)(3) is amended to read as follows:

(B) Special Rules for Low-Income Housing and Rehabilitation Credits.--

(1) Low-Income Housing Credit. -- Subparagraph (A) shall not apply to the extent that the passive activity credit for a taxable year is attributable to any credit to which paragraph (6)(B)(i) applies.

(2) Rehabilitation Credit. - In the case of any portion of the passive activity credit for any taxable year which is attributable to any credit to which paragraph (6)(B)(ii) applies, subparagraph (A) shall be applied by substituting "$200,000" for "$100,000."

B. Reason For Change. The low-income housing credit is currently subject to the limitations on the use of the general business credits, including, most significantly, the restriction which precludes an investor from offsetting any alternative minimum tax liability by the allowable low-income housing credit. Due to the changes brought about by the 1986 Act--i.e., the narrowing of the tax rates between the regular and alternative minimum tax, the expansion of the category of items subject to the tax, and the phase-out of the $40,000/$30,000 exemption-- significantly more taxpayers, particularly those in the high income brackets, will become subject to the alternative minimum tax. As a result, both corporate and individual investors are uncertain as to whether they can utilize the low-income housing credits which are potentially available to them over the 10-year period. This uncertainty has contributed to the reluctance on the part of many investors to commit capital to housing projects.

In addition, for purposes of the rules limiting passive loss deductions, the credits (but not the losses) from low-income housing projects are deemed attributable to rental real estate activities in which the taxpayer actively participates. The credits may be used to offset tax on up to $25,000 of non-passive income, subject, however, to a phase-out of the allowance between $200,000 and $250,000 of adjusted gross income (ignoring passive losses).

Given the importance of providing low-income housing, there is no reason why the allowance should be phased-out for individuals earning over $200,000. It should make no difference whether the credits are used by wealthy individuals or individuals with more modest means. However, by combining the phase-out provision with the rule barring use of the credit against the AMT, Congress has, in effect, set up unintented roadblocks to the implementation of the credit program.

It is evident that the credit is the "hook" that attracts private sector capital to what would otherwise be an unprofitable investment. By precluding high-income individuals from using the credit, Congress is alienating the group which has traditionally possessed the funds and the tax motivation to invest in low-income housing projects. There is no reason to deny housing to the needy because of some arbitrary decision to limit the utilization of the credit by wealthy individuals.

The proposed amendments are modest attempts to alleviate several of these obstacles by eliminating the phase-out of the $25,000 allowance and permitting investors to offset their AMT by the low-income housing credit. The proposal would still leave intact the $25,000 limitation (which, after 1987, effectively caps the credit at $7,000 in terms of its use against taxes on non-passive income), as well as the other general business credit limitations. Moreover, the government's purse remains adequately protected against wholesale use of the credit by the rigid income targeting rules, the volume caps on credit authority, and the limitations on carryovers of unused credits which are currently contained in the Code.

VIII. Tax Shelter Provisions

A(1) Statutory Change. To assure taxpayers that losses arising from an investment in a low-income housing syndication will not be treated as hobby losses--

> Subsection (c) of section 183 is amended by adding at the end thereof the following sentence: "Investment in an entity formed primarily for the purpose of owning low-income housing in a manner that will enable such entity (or its owners) to secure a credit under section 42 shall constitute an activity engaged in for profit."

A(2) Statutory Change. To provide that low-income housing syndications will not be treated as "tax shelters" for purposes of the substantial understatement penalty--

> Clause (ii) of section 6661(b)(2)(C) is amended by adding at the end thereof the following sentence: "The term 'tax shelter' shall not include an entity formed primarily for the purpose of owning low-income housing in a manner that will enable such entity (or its owners) to secure a credit under section 42."

B. Reason for Change. Any investment in an activity qualifying for the low-income housing credit should be exempt from the purview of Code section 183 (which prohibits the deduction of losses attributable to investments not "engaged in for profit"), as well as the more rigid standards which are applied under section 6661(b)(1) to understatements attributable to "tax shelter" investments. Present practice assumes that investors in low-income housing projects are exempt from such rules, and the IRS' current ruling position is consonant with this practice, at least insofar as it applies to section 183. See Rev. Rul. 77-300, Priv. Ltr. Rul. 8531065, and G.C.M. 38117. The proposed amendment, therefore, represents a long-overdue codification of this informal rule, and would remove any lingering doubt as to the precise reach of the statutes in question.

IX. Allocation of Credit by Partnerships

A. Statutory Change. To allow for the allocation of low-income housing credits among partners of a partnership in accordance with the manner in which they contributed the capital used to acquire or improve the project--

Subsection (m) of section 42 shall be amended by adding at the end thereof the following sentence:

It is contemplated that the Secretary will amend the regulations under section 704(b) to permit a partnership, at its election, to allocate the credit allowable under this section among its partners in any manner which reasonably approximates the manner in which the partners' respective capital contributions were used to acquire the property or fund the expenditures giving rise to the credit. In addition, the regulations should provide that the credit is to accrue ratably over the taxable year from the date the credit is initially available to the partnership, as determined under such monthly, semi-monthly or daily convention as is permitted under section 706 and the regulations thereunder.

B. Reason For Change. Section 42 provides no guidance as to whether the low-income housing credit may be specially allocated to those partners who funded the expenditures giving rise to the credit. Under the section 704(b) regulations, it appears that the credit must be allocated on a basis consistent with the allocation of the partnership's depreciation deductions. Any such requirement constitutes a major deficiency in the statutory scheme insofar as it would impede a partnership's ability to attract capital for urgently needed rehabilitation expenditures.

The proposed amendment solves this problem authorizing the Secretary to issue regulations which would permit a partnership, at its election, to allocate credits on a basis that is reasonably related to the funding of the expenditures which gave rise to the credit. Such an allocation scheme is more consonant with one of the purposes of the statute, namely to provide tax incentives solely to those investors who provide the capital needed to acquire or renovate a project.

Section 42 should also make clear that the credits are allocable on a monthly or more frequent basis (i.e., daily basis), thus entitling new partners (or existing partners making capital contributions) to an allocation of credits commensurate with the amount of their capital contributions and the dates they made such contributions.

X. Transitional Rules

A(1) Statutory Change. To provide for a transitional rule for binding contracts, entitling taxpayers to the credit for the fourth quarter of 1987 and the first quarter of 1988--

Subparagraph (B) of section 42(f)(2) is redesignated as subparagraph (C), and the following subparagraph is added after subparagraph (A):

(B) Transitional Rule.--If--

(i) the taxpayer has entered into a binding contract to purchase the low-income building as of September 30, 1987,

(ii) the taxpayer and the state where the low-income building is located have entered into an agreement described in subsection (b)(2)(A)(ii)(I) [as added by S. 1350 or H.R. 2636] on or before December 31, 1987, and

(iii) the conveyance of the low-income building occurs and all other requirements of federal, state and local governmental agencies relating to such conveyance have been substantially complied with by the due date of the taxpayer's 1987 income tax return (not taking into account any extension period),

then, for purposes of this section, such building will be treated as having been placed in service during the period beginning on October 1, 1987 and ending on April 15, 1988 (or the date on which such building is actually placed in service, if earlier).

B(1) Reason For Change. The process of obtaining a credit under section 42 requires, in effect, approval of two agencies. First, the transfer of the building must be approved by HUD (or other appropriate agency), and, second, the taxpayer must receive an allocation of credits from the appropriate state agency. Significant delays are inherent in such a process due to the complex regulatory requirements and the fact that, for the most part, the state agencies do not yet have the machinery in place to implement the allocation program.

All of this has created investor uncertainty as to whether credits will be available in 1987 (or indeed by early to mid-1988). Such uncertainty has hampered current efforts to raise capital, and it is suggested that this problem could be alleviated, at least in part, by assuring investors that if certain strict criteria are met they will be entitled to some portion of the credit during 1987 and early 1988, notwithstanding that the project is not placed in service until April 15, 1988.

A(2) Statutory Change. To provide for nonpassive treatment of income and credits falling under the transitional relief provision contained in section 502 of the Tax Reform Act of 1986--

Subsection (a) of section 502 of the Tax Reform Act of 1986 is amended by substituting "Any income, loss, or credit (other than a credit determined under section 42 of the Internal Revenue Code of 1986)" for the phrase "Any loss" and by substituting the phrase "income, loss, or credit" for the phrase "a loss".

B(2) Reason For Change. Section 502 of the 1986 Act provides transitional relief for investors in low-income housing projects which were placed in service prior to 1987 and which are therefore ineligible for the credit. The transitional rule allows the investors to treat their losses from such activities as nonpassive losses for a specified period of time. However, in what was an apparent oversight, the rule fails to provide similar relief for the rehabilitation credit. The proposed amendment seeks to rectify this omission.

(5067N)
(7/2/87)

PART XI

SUBJECT: Amendment of Section 1039 of the Internal Revenue Code In Conjunction with Technical Corrections to the Low Income Housing Credits Provisions

The Tax Reform Act of 1986 recognized the importance of continuing to use tax incentives to preserve the existing inventory of low income housing. The 1986 Act enacted a new program of "Low Income Housing Credits" to encourage the private sector, through the use of tax credits, to acquire, improve and maintain (for the benefit of low income tenants) existing low income housing projects. Proposed technical corrections to the 1986 Act, designed to make the credits program more usable, evidence the continued commitment of the Congress to encourage effective use of this tax credit program as a tool to preserve and improve existing low income housing.

At the same time, legislation has been suggested as an amendment to Section 1039 of the Internal Revenue Code, which would limit the federal income tax incurred upon a disposition of low income housing property to a tax only on the cash received where the disposition is made under circumstances which assure the continued long term use of the property as low income housing. A copy of the suggested legislation and the reasons favoring its enactment it attached.

It is proposed that the suggested amendment of Section 1039 be considered as part of the Technical Corrections to the credits program because:

(1) Both the Section 1039 Amendment and the Technical Corrections to the credits program seek the same result -- the preservation of our low income housing -- at a time when our existing inventory of low income housing is threatened by deterioration and by increased market pressure to convert the existing stock to market rents, thereby displacing low income tenants and exacerbating the homeless problem.

(2) Under present law, the federal income tax incurred upon a disposition of low income housing is often a significant obstacle to would-be private sector purchasers who wish to make use of the Low Income Housing Credits program. The need of sellers to get enough cash to pay their tax on sale may either (a) completely frustrate an otherwise desirable transfer to a new investment group motivated to preserve and improve the housing, or (b) unnecessarily limit the amount of private capital available to meet the needs of the property. The Section 1039 Amendment would eliminate this obstacle and encourage the intended and much-needed use of the credits program.

(3) The need to preserve our low income housing is urgent and the opportunity to amend Section 1039 now, in conjunction with the Technical Corrections Act, represents a real opportunity to make an immediate positive impact upon a very real and pressing problem, an opportunity which should not be missed.

(4) The proposed Section 1039 Amendment should have no budget impact. The excused income tax on disposition would not have been realized anyway, because absent this legislative inducement, the sellers would simply hold on to the property. Any revenue loss incident to use of the Low Income Housing Credits has already been taken into account and is subject to the prevailing volume ceiling on use of the credits.

PRESERVATION OF AFFORDABLE HOUSING
A NATIONAL HOUSING POLICY

Despite massive programs legislated in the 60's and 70's, designed to increase the supply of low and moderate income housing, we are today faced with a housing crisis greater than at any time since WWII. We have allocated hundreds of billions of dollars for interest and rent subsidies to build a basic low income housing inventory, and we are on the verge of seeing it move out of the reach of the tenants it was built to serve. At a time when administration policies and budget constraints have all but eliminated the availablity of funds to build additional housing, we are ironically faced with the prospects of losing much of what we have paid so much to build.

First and foremost, Congress must enunciate a clear mandate for preservation of our existing housing stock as a national policy and simultaneously enact the necessary legislation to assure that we start to move in the direction of preserving housing as a national resource.

A national housing policy, with preservation as its cornerstone, is not just an emergency measure designed to contain a few local brush fires. It is an economical and practical approach to assuring an adequate supply of affordable housing for all American families. It will cost the government far less in the next decade to use our limited resources to preserve what exists than it would cost to attempt to build replacement housing.

A well designed preservation program will, in the long run, increase the supply of affordable housing by arresting the eroding influence of deterioration and abandonment which claims thousands of rental units from our housing stock each year. Of even greater importance, we must curtail the process of gentrification which wrests existing housing from the reach of lower income families through escalating rents and condiminium conversion to serve middle and upper income families. The forces of deteriorization and marketization have reduced our stock of affordable housing by far greater numbers than all of the housing units we have built under Federal programs in the past 20 years. By taking immediate action in the form of new legislation we can arrest this accelerating trend toward a declining affordable housing stock.

To effectively design the necessary legislative initiatives we have to confront some of the realities of the present low and moderate income housing stock. We tend to identify that stock as primarily the rental housing built under one or more federal programs since the late sixties and benefiting from some form of federal subsidy - interest reduction or rent supplement. Though this constitutes the largest, easiest indentifiable portion of the inventory, there is an even larger inventory of rental units serving families with incomes below 80% of the median.

The targeted housing stock for preservation should be all of the rental properties which today serve low and moderate income tenants. To relate that to the simplicity of a month's rent, we must focus on all rental housing with average rents at or below $400/month. We are thereby defining the housing needs of families with incomes in the area of $20,000/year. In some areas with higher median income, top rents may be higher and in others with lower median incomes top rents may be "low" $300/month. It is this rental housing, now able to physically and economically function in these rental ranges, that we must aim to preserve as affordable housing.

Most of this existing housing stock is owned by private investors who, as in the case of the HUD financed stock, acquired their ownership interest for a combination of tax incentives and longer term profit potential. The primary investment incentive for the billions invested by private owners in the HUD housing stock was clearly tax incentives. In most cases, the limitations placed on rents and the incomes of tenants effectively curtailed other economic benefits for twenty years from the date the property was built. With their tax benefit virtually exhausted by the length of time of ownership and by the 1986 tax law changes, owners must find economically sound methods for disposing of their investment. Two basic directions are available to all owners of low and moderate income housing. The most desirable economic direction for the private investor/owner is to "marketize" his property. In effect, he must move toward market rents to increase the income available for debt service and then either 1) refinance the property for more than the existing debt, or 2) sell the property to a buyer based on its distributable cash flow. to illustrate:

Assume an existing 221 D-3 property built in 1968:

Size:	200 Units
Debt:	$2,400,000 mortgage @ 3% interest
Debt Service:	$120,000/year Principal & Interest
Current Rents average	$375/mo or $4500/unit/year
Annual Rent Roll:	$900,000
Operating Expenses:	$755,000 (Approx. $3750/unit/year)
Net Dividend Distributable	$25,000/year

Assume the median income for the area in which the property is located is $25,000/year and the property could be marketed to families with incomes in the $25,000 - $30,000 range with modest physical upgrading at rents averaging $550/mo. or $6600/yr.

Rental Income:	$1,320,000
Expenses:	800,000
Available for Debt Service:	520,000

Option 1. Obtain a new mortgage for $5,000,000 @ 9%
<u>Result:</u> $2,600,000 cash to owners tax free

Option 2. Sell for $6,000,000 - based on net cash flow capitalized @ 8½%-9%.
<u>Result:</u> $3,600,000 cash to owners less tax due on sale.

The owner is clearly motivated to move in this direction in the course of which he would be compelled to displace many of the existing tenants. If their current rents are $375/mo. they would have to bear a 50% rent increase to remain under the new rents. The property would therefore be lost to the low income housing stock with all of the social displacement and upheaval inherent in evicting 200 families.

If the owners can not see a way to marketize the project, they will lose interest in the property and allow it to deteriorate. They would have no incentive to invest additional dollars for maintenance and physical upgrading and eventually the property will be lost as safe, adequate housing for low income tenants - a pattern we have seen all too often in the past.

To avoid these paths toward housing loss, we must develop alternative economic incentives for private owners to continue the properties as affordable housing or to transfer ownership of the property to new owners who are willing to provide the necessary resources to preserve the property as low and moderate income housing.

No one form of incentive alone will serve to meet all of the circumstances affecting the present housing stock. It is feasible however, to evolve a number of different, but related elements which individually and in combination begin the process of moving the existing affordable housing inventory into ownership entities whose objective is consistent with a national housing policy of preservation.

One of the most immediate threats to the housing stock are the circumstances surrounding the existing HUD inventory eligible for mortgage repayment in the next several years. The owners of many of these properties are at this point realizing very little of tangible economic value, however, they are faced with an overhanging liability if they sell the property to a new entity. As an example:

Assume the owners of the property described above acquired it in 1968 and invested a total of $500,000 of equity capital. During the period they have owned the property, they have probably taken almost $1,750,000 in tax deductions. In effect, they have recovered their initial $500,000 investment plus a profit to date. Now, however, if they sell the property, they will recognize a gain of approximately $1,250,000 plus any cash they receive. If they were to receive $500,000 in cash, they would pay a tax of approximately $550,000 or $50,000 more than they received. This overhanging liability is of continuing concern to these owners, first because it is doubtful they could find a buyer for the property as low income housing and they are uncertain as to their ability to marketize the property at a profit - the course they will try to pursue if no other alternative is available.

It might be pointed out at this time that the original legislation that created many of the incentives to attract private capital to build this housing envisioned this problem in 1968-69. That legislation created an exit program for some of the owners through Section 1039, whereby the owners could convey the property to a suitable non-profit or tenant group and reinvest the proceeds in another project, thereby allowing the basis in the old property to carry over to the new. Unfortunately, such reinvestment opportunities are virtually extinct so that option has become of questionable value.

Reestablishing this incentive is one method for preserving some of the low income housing stock that might otherwise be lost in the next five to seven years. A legislative proposal to redefine the original Section 1039 provision in the light of present day circumstances and needs is attached as Exhibit A. This provision, when enacted, will provide a positive incentive to existing owners of low income housing projects to opt for selling them to new entities committed to their maintenance as affordable housing.

From the point of view of many passive owners of HUD properties, the uncertainty of the overhanging tax liability is cause enough to accept an opportunity to sell the property to a new entity substantially below market value - often for the mere assumption of the debt. The very passive, uninvolved position of most investors will move them to accept a known result and the elimination of pending future liability versus the uncertainty of being able to marketize their property to sell at a profit.

It is reasonable to assume that over half of the HUD projects owned by limited partnerships would accept this option, particularly if the legislation carried a "sunset" provision of three years from date of enactment. Project owners who have five or more years remaining on their low income use restrictiions would be sorely pressed to act now versus waiting for five or more years to determine market conditions favorable for increasing rents and refinancing with relatively insignificant current tax benefits. A significant segment of the HUD stock would move to new owning entities of the type envisioned in the legislative propoals.

The pervasive question of the loss of revenue to the Treasury of this proposal is commented on in the attached exhibit. Current owners will not sell their properties, thereby incurring taxable income, unless the proceeds of sale are more than sufficient to cover their tax liabilities. The result of most of such sales would be to remove the housing from the low income inventory.

In fact, it could be suggested that the Treasury would gain revenue in the near term five year period since owners exercising the option of a revised Section 1039 sale would be foregoing additional passive losses which might be offsetting some of their passive income or accruing unused passive income to eventually offset the taxable effect of a future more profitable sale. This proposed legislation should clearly have no negative budget effect.

The proposed legislation recognizes at least three types of prospective qualified purchasers, each meeting certain prescribed circumstances which might prevail in the housing inventory as a whole. The overriding consideration must be a clear binding obligation to maintain the property for defined levels of low income use. A secondary qualifying element for affecting this type of transaction is movement in the direction of achieving ownership of the property by the tenants themselves. This objective was apparent as national housing policy in the 1969 legislation, but is even more valid today. If, through a new defined national housing policy, we can enact the necessary enabling legislation to bring about large scale ownership of housing by the tenants - with clear enforceable requirements for continued maintenance of the housing at affordable levels through any future ownership changes, we will have completed the logical social and economic cycle of placing control of the housing directly in the hands of those with the largest interest in its preservation.

However, the direct step to tenant ownership may not be realizable today. Existing tenants, for the most part, are not organized and trained to assume the burdens of ownership. Many of the properties are older and need capital infusions for maintenance and upgrading. Suitable financing mechanisms and enabling cooperative legislation, both local and national, need study and revision. By qualifying prospective buyers as private partnerships willing to provide the capital and management resources and/or community non-profit housing corporation with resources to meet property and tenant needs, a transitional condition is created whereby we can facilitate the movement of property from the ownership by existing investors who are not commited to preservation for low income use, to new ownership with a clear mandate and obligation to preserve the property as affordable housing. The new resources provided by these new, qualified owning entities will further assure property preservation and move in the direction of tenant control.

Certainly all owners will not elect to take advantage of a modified Section 1039 provision. This will be particularly true of owners of property very favorably located in high median income areas where the prospect of eliminating the low income tenant restrictions and bringing the properties to market rents or converting to condominiums or cooperatives is a very real and present prospect. It may not be possible to intercept all of these flights from the inventory, but we might achieve an effective compromise in at least many of these serious and volatile situations.

A LEGISLATIVE PROPOSAL FOR PRESERVATION OF EXISTING LOW AND MODERATE INCOME HOUSING BY DEFINING CERTAIN CONDITIONS & INCENTIVES FOR CHANGES OF OWNERSHIP

Summary - Proposed Legislation

The proposed legislation is necessary to preserve existing low and moderate income rental housing, and to assure its continued availability as safe and sound housing for the families for which it was originally built. General Accounting Office studies indicate that up to 500,000 units could be lost to the nation's low income housing inventory by 1995 through rent increases and condominium conversions. This legislation provides a method for preserving this valuable housing stock by encouraging a transfer of ownership to new entities who agree to extend the life of the housing for low income tenants and develop methods for bringing the housing within the control of its tenants.

Existing owners were encouraged to invest in the housing by tax incentives. Having benefited by these incentives, most owners retain ownership only because of the tax liabilities of a sale. Section 1039 of the Tax Reform Act of 1969 provided a method to solve the problem. A modification of that existing section of the tax law combined with clearly defined qualifying conditions will significantly strengthen a national housing policy of housing preservation.

A. Definition of a "Qualified Housing Project"

1. Any project assisted under the 221(d) (3), 236 or FmHa 515 program, and any project where 50% or more of the tenants receive Section 8 assistance.

2. Any other project insured or assisted by HUD1/ if, at the time of the "approved disposition":

   a. No less than 75% of the units are leased to tenants whose incomes are at or below 80% of area median income, and

   b. No less than 25% of such units are leased to tenants at or below 50% of area median income, and

   c. Rental charges for units occupied by such tenants do not exceed 30% of 50% of area median income, or, 80% of area median income.

B. Nonrecognition of Gain for Certain Approved Dispositions:

If a qualified housing project is sold or disposed of by a taxpayer in an approved disposition, as defined below, then, at the election of the taxpayer, and notwithstanding any other provision of federal law, gain from the disposition shall be recognized only to the extent that and only in the

1/This would include, without limitation, projects insured under 207, 220, 221(d)(3)(Market), 221(d)(4), 223(f), 231 Elderly Market, 608 Veteran Housing/803 Military and properties assisted under the 312 multifamily housing program.

2. Is There any Provision in Existing Tax Law Specifically to Support the Type of Activity Being Proposed?

Yes. The Tax Reform Act of 1969 contained two distinct measures designed to encourage sale of properties to coops. First, Section 1039 provided for a deferral of tax on gain when owners of 221(d) (3) and 236 projects sold their projects to tenants or a nonprofit organization formed on behalf of the tenants.

Sec. 1039 (1954 Code). (a) NONRECOGNITION OF GAIN.-if-

(1) a qualified housing project is sold or disposed of by the taxpayer in an approved disposition, and

(2) within the reinvestment period the taxpayer constructs, reconstructs or acquires another qualified housing project,

then, at the election of the taxpayer, gain from such approved disposition shall be recognized only to the extent that the net amount realized on such approved disposition exceeds the cost of such other qualified housing project. An election under this subsection shall be made at such time and in such manner as the Secretary prescribes by regulations.

Section 1039 requires the seller to reinvest in another 221(d) (3) or 236 project. This provision has rarely, if ever, been used because of the carry-over basis and reinvestment requirements. A second but unrelated provision in the 1969 tax legislation was Section 167(k), permitting five year amortization of rehab expenses incurred on low-income units. Generally only $20,000 per unit of rehab expenses qualified for five year amortization. If, however, the rehabilitation was done under an approved government plan and units were held for sale to the tenants, up to $40,000 per unit in rehab expenses qualified. The special tenant disposition provision was frequently used by nonprofit community development corporations. Section 167(k) expired on December 31, 1986 and was not renewed. Congress replaced Section 167(k) with the new low-income housing tax credit program but failed to provide any comparable incentive for subsequent disposition to tenant ownership.

3. What Revenue Loss Will Result from this Legislation?

There will be no reduction in current tax revenue to the government. Existing owners of qualified projects will not sell their properties and incur a tax liability. They will retain ownership of the properties and either a) allow them to deteriorate, or b) attempt to raise rents in anticipation of conversion to market rents or condominium conversion. In either case, the government will receive no additional revenue, but could lose as many as 500,000 low income units from the national housing stock over the next ten years. The cost of replacing these units or otherwise subsidizing the affected families could eventually cost the government $25 billion.

4. Why will Owners of Existing Qualified Properties Avail Themselves of this Proposed Program?

Because of the passive loss restrictions in the tax legislatiion, most investors in ACPS depreciated properties have been stripped of the benefit of their investment. The transition rule for low-income housing does not cover many of these investors because in order to qualify the investor must have made his initial investment after December 31, 1983 and, as of December 31, 1986, must have 50% or more of his total original obligated investment outstanding. Over 90% of the existing assisted inventory does not qualify for this transition benefit, and investors in such projects are relegated to the passive loss phase-out rules available to all rental properties. Prepayments and rental subsidy contract cancellations will be exacerbated and accelerated because of the passive loss restrictions and limited coverage of the low-income housing transition rule.

In effect, owners of existing HUD, State Agency, and FmHA projects have little or no continuing economic benefit from ownership, but do have a lingering potential tax liability. Their only recourse would be to try to increase the market value by working toward taking their property out of the low income housing stock, or availing themselves of this proposed sale to a qualified purchaser and thereby eliminating their tax liability. Preliminary analyses by private sector groups indicates that 50% - 70% of existing assisted housing projects would take advantage of this qualified sale transaction, thereby protecting the majority of the housing inventory.

5. What is HUD's Policy on Transfer of Privately Owned HUD-Assisted Projects to Cooperatives or Nonprofit Ownership?

HUD's Transfer of Physical Assets administrative policies contain special requirements for transfers to cooperative and nonprofit ownership. The question of mortgagee approval for coop conversions was litigated in the Boston Five Cents Savings Bank v. Pierce case. HUD's TPA policies impose far more onerous requirements on nonprofit transferees than profit-motivated transferees. These requirements, formulated in 1984, virtually preclude transfers from profit-motivated to nonprofit ownership. No legislation exists on the Transfer of Physical Assets process for FmHA or HUD projects. HUD has promulgated regulations with respect to a limited catagory of transfers (nonprofit of profit-motivated ownership.) 24 C.F.R. Part 265. This legislation establishes conditions for transfer of ownership consistent with national housing policy.

Summary - Proposed Legislation

The proposed legislation is necessary to preserve existing low and moderate income rental housing, and to assure its continued availability as safe and sound housing for the families for which it was originally built. General Accounting Office studies indicate that up to 500,000 units could be lost to the nation's low income housing inventory by 1995 through rent increases and condominium conversions. This legislation provides a method for preserving this valuable housing stock by encouraging a transfer of ownership to new entities who agree to extend the life of the housing for low income tenants and develop methods for bringing the housing within the control of its tenants.

Existing owners were encouraged to invest in the housing by tax incentives. Having benefited by these incentives, most owners retain ownership only because of the tax liabilities of a sale. Section 1039 of the Tax Reform Act of 1969 provided a method to solve the problem. A modification of that existing section of the tax law combined with clearly defined qualifying conditions will significantly strengthen a national housing policy of housing preservation.

A. Definition of a "Qualified Housing Project"

1. Any project assisted under the 221(d) (3), 236 or FmHa 515 program, and any project where 50% or more of the tenants receive Section 8 assistance.

2. Any other project insured or assisted by HUD1/ if, at the time of the "approved disposition":

   a. No less than 75% of the units are leased to tenants whose incomes are at or below 80% of area median income, and

   b. No less than 25% of such units are leased to tenants at or below 50% of area median income, and

   c. Rental charges for units occupied by such tenants do not exceed 30% of 50% of area median income, or, 80% of area median income.

B. Nonrecognition of Gain for Certain Approved Dispositions:

If a qualified housing project is sold or disposed of by a taxpayer in an approved disposition, as defined below, then, at the election of the taxpayer, and notwithstanding any other provision of federal law, gain from the disposition shall be recognized only to the extent that and only in the

1/This would include, without limitation, projects insured under 207, 220, 221(d)(3)(Market), 221(d)(4), 223(f), 231 Elderly Market, 608 Veteran Housing/803 Military and properties assisted under the 312 multifamily housing program.

year or the years that the taxpayer receives money or other property from such sale or other disposition.

C. Definition of Approved Disposition:

The term "approved disposition" shall mean a sale or other disposition (such as a charitable contribution) of a qualified housing project to:

a. A tenant cooperative, as defined, or

b. A 501(c)(3) or (c) (4) nonprofit organization which has as one of its purposes, the preservation and maintenance of housing for low and moderate income people, or

c. An agency of a state or local government, including any non-profit housing development corporation established by a state or local government agency. (This would include, for example, the Montgomery County Housing Opportunities Commission), or

d. A for-profit entity that, at the time of the approved disposition, agrees to provide the capital necessary for needed repairs and maintenance, and further agrees to develop and fund a suitable tenant coop, or a non-profit organization formed solely for the benefit of the tenants, and in turn sell the property to such organization within ten years of the approved disposition, as discussed herein.

In order to satisfy the requirement of an "approved disposition", the sale or other disposition must be approved by the Secretary of the United States Department of Housing and Urban Development, the Secretary of the Farmers' Home Administration, in the case of FmHA assisted projects, or the appropriate State Housing Finance Agency.

D. Criteria that the Secretary of HUD or FmHA Shall Follow in Approving Such Disposition:

1. That the transferee satisfies one of the four definitions described above.

2. That within 24 months of the approved disposition (preliminary TPA approval) the project will be in sound physical and financial condition.

3. That the purchase price of the project shall equal the remaining mortgage debt or a price that does not exceed 80% of fair market value given the restricted conditions of the regulated use of the property.

4. That the Regulatory Agreement and Deed of Trust contain provisions requiring low and moderate income occupancy (50% of units occupied by tenants at or below 80% of area median income; 25% of units occupied by tenants at or below 25% of median income) at affordable rents in perpetuity. The Regulatory Agreement and Deed shall further provide that upon breach of the low income use restrictions the Secretary may exercise any remedies, and that the Secretary and occupants of the housing may bring suit for specific performance.

5. That no tenant in occupancy at the time of disposition shall be evicted except for cause.

6. In the case of disposition to a cooperative, that at least 50% of the existing tenants have expressed an interest in cooperative conversion.

E. Disposition to a For Profit Entity that Agrees to Convey the Property to the Tenants within Ten Years:

1. Such purchasers are eligible for the acquisition and rehabilitation low income housing tax credit if they receive an allocation and

credits and otherwise comply with the requirements of this program. The provisions of Section 42 are modified as follows:

a. Secondary financing provided by Sellers of HUD and FmHA assisted projects who elect to participate in approved dispositions shall be treated as "qualified nonrecourse debt" and included in the eligible and qualified basis for purposes of computing the acquisition tax credit. Further, the Seller shall not be required to recognize as income accured but unpaid interest on purchase money mortgages. (Exception to OID rules). (Section 42 (k) provides an exception to the at-risk rules only for purchase money financing from a qualified nonprofit organization).

b. No bond shall be required at the time of conveyance of the project to the tenants or a nonprofit.

2. The purchaser must assure the availability of the capital as determined by HUD, FmHA, or the applicable State Housing Finance Agency for repairing and maintaining the property as safe and decent housing in accordance with all applicable regulations.

3. The potential purchaser must, as part of its proposal to the applicable agency for approval of acquisition of the property, submit a detailed plan for eventual conversion to tenant ownership which shall include provision for funding education and training programs designed to develop tenant skills in owning and operating the property.

F. Additional Assistance

HUD is authorized to provide Section 8 Loan Management assistance if this will facilitate conversion to an eligible entity.

DRAFT
2/24/87

NONRECOGNITION OF GAIN ON CERTAIN SALES OF LOW-INCOME HOUSING PROJECTS

PROPOSED AMENDMENTS OF THE INTERNAL REVENUE CODE OF 1986

Section 1039 (relating to certain sales of low-income housing projects) is amended to read as follows:

"SEC. 1039. CERTAIN SALES OF LOW-INCOME HOUSING PROJECTS.

(a) Nonrecognition of Gain. -- If a qualified housing project is sold or disposed of by the taxpayer in an approved disposition, gain from such approved disposition, at the election of the taxpayer, shall be recognized only to the extent that the net amount realized on such approved disposition exceeds the adjusted basis (provided in section 1011 for determining gain) of such qualified housing project. An election under this subsection shall be made at such time and in such manner as the Secretary prescribes by regulations.

(b) Definitions. -- For purposes of this section --

(1) Qualified Housing Project. -- The term "qualified housing project" means --

(A) Any property described in clause (i) or (iv) of section 1250(a)(1)(B) (relating to low-income housing),

(B) any building described in subparagraph (B) of section 167(k)(3) (relating to low-income rental housing) if 50 percent or more of the dwelling units in such building are held for occupancy on a rental basis by families and individuals of low or moderate income in accordance with the requirements of such subparagraph (B),

(C) any project described in subsection (g) of section 42 (relating to qualified low-income housing projects), or

(D) any project assisted, financed, or with respect to which a mortgage is insured, by the U.S. Department of Housing and Urban Development if --

(i) 75 percent or more of the dwelling units in such project is occupied by families or individuals whose income is 80 percent or less of area median gross income,

(ii) 25 percent or more of the dwelling units in such project is occupied by families or individuals whose income is 50 percent or less of area median gross income, and

(iii) Such dwelling units are rent-restricted in accordance with rules similar to the rules of section 42(g)(2).

(2) Approved Disposition. -- The term "approved disposition" means a sale or other disposition of a qualified housing project, which sale or disposition is approved by the Secretary of Housing and Urban Development or the Administrator of the Farmers Home Administration of the U.S. Department of Agriculture, as appropriate, under [insert reference to proposed legislation] or regulations issued thereunder. Evidence of such approval shall be attached to any tax return or statement in which an election under subsection (a) is made.

(3) Net Amount Realized -- The net amount realized on an approved disposition of a qualified housing project is the amount realized reduced by --

(A) the expenses paid or incurred which are directly connected with such approved disposition, including any amount paid for repairs to such qualified housing project required as a condition of approval of the disposition,

(B) the amount of taxes (other than income taxes) paid or incurred which are attributable to such approved disposition, and

(C) the excess of the amount of liabilities from which the taxpayer is discharged as a result of such approved disposition (to the extent such liabilities are included in amount realized under section 1001(b)) over the adjusted basis of such qualified housing project.

(c) No Bargain Sale to a Charitable Organization. -- If an election is made under subsection (a), no deduction shall be allowed under section 170 (relating to charitable contributions) by reason of an approved disposition."

Section 1245 (relating to gain from dispositions of certain depreciable property) is amended by inserting at the end of subsection (b) thereof a new paragraph (9) to read as follows:

"(9) Disposition of Qualified Housing Project. -- If section 1245 property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1039, the amount of gain recognized by the transferor under subsection (a) shall not exceed the amount of gain recognized on the disposition (determined without regard to this section)."

Section 1250 (relating to gain from dispositions of certain depreciable realty) is amended by striking out paragraph (8) of subsection (d) thereof, and inserting in lieu thereof a new paragraph (8) as follows:

"(8) Disposition of Qualified Housing Project. -- If section 1250 property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1039, the amount of gain recognized by the transferor under subsection (a) shall not exceed the amount of gain recognized on the disposition (determined without regard to this section)."

(4) Date of expiration. -- This provision shall expire on December 31, 1989.

Comments for

The Associated General Contractors of America

Comments on Technical Corrections
to the Tax Reform Act of 1986

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,400 of America's leading general contracting construction firms. These contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial, and municipal-utility facilities, and employ more than 3,400,000 individuals. AGC appreciates the opportunity to provide comments prior to the Committee's consideration of the Technical Corrections Act of 1987, H.R. 2636.

New Accounting Methods for Long-term Contracts Are Extremely Difficult for Construction Firms to Administer

The Tax Reform Act of 1986 requires firms with more than $10 million in annual gross receipts to use one of two new accounting methods for long-term contracts entered into after February 28, 1986. One method, the percentage of completion method, recognizes income for tax purposes according to the percentage of the contract completed during the taxable year. The progress toward completion of the contract must be calculated by comparing the costs incurred on the project during the taxable year to the total estimated costs for the contract.

The second allowable method is the percentage of completion-capitalized cost method (40-60 method). Under this method 40 percent of the contract items are accounted for using the percentage of completion method and 60 percent of the items are accounted for under the taxpayer's normal method, often the completed contract method of accounting.

The percentage of completion method and the 40-60 method both contain a provision called the "look-back" method to correct for estimation errors. Due to the inherent difficulties in forecasting the profit or loss on a contract, the Tax Reform Act of 1986 provides a way for contractors to "look-back" after the completion of a contract when actual costs and contract price are known.

- The contractor recalculates all of the computations relating to each contract based on actual figures and recomputes the tax owed in each year of the contract. Interest would then be paid to the contractor by the Treasury if overpayments were made during the life of the contract, or the taxpayer would pay interest to the Treasury if underpayments had been made in years prior to contract completion.

While the goal of the look-back method is admirable, many serious problems remain in applying the method in the construction industry. The problems, which at times seem insurmountable, include integrating the look-back rule with the new alternative minimum tax and the correct treatment of contract disputes and lawsuits.

Many construction industry taxpayers have a large number of contracts; one AGC large regional construction firm had 770 contracts last year, another contractor had 450, and a third construction firm had 360 contracts. These firms are representative of large AGC members, but they are not the largest.

Congress did exempt small construction contractors with less than $10 million in average annual gross receipts from the new accounting methods, retaining prior law for these firms. While AGC is most appreciative and supportive of this carve-out, this exclusion did not lessen the administrative burden on many firms with gross revenues above the $10 million cut-off.

To illustrate, AGC asked a small contractor with $10.3 million in volume last year to provide a profile of the firm. This contractor had 25 contracts in process during the year ranging in value from $25 thousand to $3.9 million with contract durations of from one to eighteen months. During the year the company employed 120 people consisting of a general manager, two clerks, two estimators, and 115 field personnel.

The accounting, except for writing payroll checks and preparing billings, was done by an outside firm as was the auditing and preparation of tax returns. Another $12 million building contractor is known to have 150 contracts, 50 of which may be open at the end of a year, without any additional accounting staff.

The tax accounting changes brought about by the new law on long-term contracts are both complex and difficult to administer. AGC construction contractors are very concerned about the added paperwork and administrative costs which are a direct result of the new law. The construction industry does not believe that either added costs or paperwork of this magnitude is in the best interest of the industry or national policy. These added costs are non-productive and make the industry less competitive.

An important consideration is that the industry does not believe that the revenue gained by the Treasury, if any, from the lookback provision as it now stands is a sufficient reason for burdening the industry with tremendous added costs and paperwork.

AGC supports the provision included in H.R. 2636 which authorizes the Secretary of the Treasury to simplify the allocation of costs to a contract for purposes of applying the percentage of completion method. However, serious paperwork and administrative problems have not yet been addressed. Therefore, the industry is proposing that Congress consider several additional technical corrections to minimize the burden without jeopardizing the intent of Congress with regard to the accounting methods.

Proposed Technical Correction to Provide a De Minimus Rule for the Lookback Method

AGC recommends that a de minimus rule be made available to contractors to reduce the administrative burden of the look-back method contained in section 460 (a) and (b). The proposed rule would exempt contracts from the look-back method if the 1) contract price is less than $1,000,000, 2) the contract is completed within two years, and 3) the contract price is less than 1 percent of the taxpayer's average gross receipts for the prior three years.

The sole purpose of this proposed provision is to minimize the administrative burden of the lookback method. The provision should not have a revenue impact on the Treasury, as the lookback method can work to either the taxpayer's benefit or the Treasury's depending on the direction of the estimation error.

As an additional safeguard for the Treasury, AGC calculated that for the contractors using this rule almost all of their contract revenue would be retained under the look-back method. Data provided to the Joint Committee on Taxation by four large AGC members showed that the proposed rule would retain subject to the look-back method 96 percent, 93 percent, 99.7 percent, and 95 percent of their contract revenue, respectively. The value of the rule is that while most of the contract revenue was retained, the rule would minimize the lookback paperwork by excluding 78 percent, 77 percent, 9 percent, and 94 percent of their contracts, respectively.

AGC strongly urges the Committee to adopt this provision during consideration of the Technical Corrections measure to reduce the intent of the new law.

Proposed Technical Correction to Allow Small Contractors to Use Financial Statement Percentage of Completion to Calculate the AMT Percentage of Completion Preference

The new corporate alternative minimum tax (AMT) requires the taxable income of a taxpayer engaged in long-term contracts to be computed using the new percentage of completion method as modified by Section 460 (b). However, during the mark-up of the Tax Reform Act of 1986 in the Ways and Means Committee the Committee recognized that many small construction contractors do not have sufficient resources to comply with the new long-term contract accounting methods.

The Committee therefore adopted an exclusion from the new long-term contract accounting methods for contractors with less than $10 million in average annual gross receipts. These contractors are allowed to continue using their normal method of accounting as under prior law.

These contractors with receipts of less than $10 million would therefore have no reason to compute the new, complicated percentage of completion method except for the requirement that all contractors compute it as the basis for the AMT calculation. AGC believes that this is clearly contradictory, and urges the Congress to adopt another acceptable method of computation of the AMT calculation for contractors qualifying for the small contractor exclusion.

One proposal would allow contractors who construct or improve real property and have less than $10 million in average annual gross receipts to use the percentage of completion method that they compute for their financial statements according to generally accepted accounting principles as the basis for the AMT computation. Many small contractors would have this available as the financial statements are generally required by bonding companies or banks in the normal course of business.

This proposal would relieve a tremendous paperwork burden being imposed on small contractors under the new law, with no identifiable revenue impact. The financial statement percentage of completion is unlikely to differ appreciably, except in computational difficulty, from the computation required by the Tax Reform Act of 1986 for these contractors.

Almost all contractors who qualify for the small contractor exception do not have in-house accounting assistance, as described above. Therefore, the new, more complicated tax method of percentage of completion would have to be computed by an outside accounting firm, at a substantial additional cost to the taxpayer. AGC strongly urges the Committee to adopt this provision during the Committee's consideration of the Technical Corrections bill.

Treatment of Recoveries from Contract Disputes and Lawsuits under the Lookback Method

During Congressional consideration of the Tax Reform Act of 1986 the appropriate treatment of recoveries and awards received by a contractor as a result of a contract dispute, arbitration, or lawsuit was never explicitly considered. The construction industry believed that current practice would be followed, and that recoveries received as a result of the pursuit of a claim or lawsuit following contract completion would be treated as a separate event under the percentage of completion method. This would be entirely consistent with the tax policy as applied to other accrual method taxpayers.

On May 4, 1987 the Joint Committee on Taxation released the General Explanation of the Tax Reform Act of 1986, termed the "Blue Book". The Blue Book stated for the first time that for purposes of the look-back method as it applies to the new percentage of completion method, the contract price shall reflect all amounts received under the contract, including amounts received after the contract completion date as a result of disputes, litigation, or settlements relating to the contract.

This statement has significant consequences for the construction industry. Lawsuits and disputes between construction contractors and owners arise all too frequently. The usual situation is one in which a contractor finds his company in a loss position as a result of one or more of the following actions by the owner or the owner's agents: 1) delay adding time-related costs, 2) disruption, 3) changed conditions from those known when the bid was made, 4) change in scope of work, or 5) termination of the contract when the owner has insufficient funds.

These events are beyond the construction contractor's control, and result in events and costs not known when entering into the contract. Therefore, the contractor will attempt to recover additional costs from the owner after contract completion. During the pursuit of a recovery, whether through negotiation, arbitration, or legal means, the contractor will incur additional legal and administrative costs. An important point to note is that because the events and costs in dispute are beyond the scope of the original contract, the contract does not give the contractor the right to a recovery in the typical case. The item is in dispute, and only after settlement is reached does the right to the income become fixed.

A simple example may clarify the significance of this one Blue Book sentence to the industry. A contractor may incur unexpected costs and be forced to pursue a lawsuit to recover his costs and profit from the owner. Although the contract may have been completed within two years, it may take an additional three, four, five, or more years after contract completion to pursue the claim to a final judgment.

Under the proposed application of the look-back method to this situation, the contractor would have to keep the contract open for the additional years required to pursue the lawsuit. When the lawsuit is finally settled a number of years later, the contractor would be required to add that amount to the contract price and allocate it back to the two years during which the original scope of work was being performed.

The contractor would not just be liable for taxes on the recovery, which of course would be wholly appropriate, but would be required to pay the Treasury interest on the taxes from the time the work was being done until the lawsuit was settled. During this time the contractor did not have the money, and did not even have the right to receive it.

Given the compounding of interest, in only a few years the firm's entire claim recovery could be absorbed by taxes and look-back interest, leaving the contractor without reimbursement for his cost overruns.

A further example shows the inequity of the tax policy being applied to construction contractors as compared to the tax treatment applied to other accrual taxpayers in similar situations. In an actual case, an AGC member firm and a supplier of mechanical equipment used in a building project jointly pursued a lawsuit against an owner. After a number of years a judgment was awarded to both the construction contractor and to the supplier.

Under the proposed interpretation of the treatment of claims and recoveries under the look-back method, the construction contractor would have to allocate his recovery back to the time when the work was being done prior to contract completion, and pay taxes <u>and look-back interest</u> on the recovered amount. The supplier, on the other hand, would only be required to record the recovery as taxable income when the lawsuit was settled and would not have to pay interest.

AGC strongly believes that this result would be inequitable. The Committee is urged to incorporate language into the Technical Corrections bill clarifying that Congressional intent was not to include dispute resolutions, claims and lawsuit recoveries under the look-back method.

July 10, 1987

The Honorable Lloyd Bentsen
Chairman
Senate Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The undersigned organizations, which represent tenants, state and local housing agencies, non-profit organizations, developers, lenders, and equity investors, all of whom are deeply involved in low-income housing production and preservation, are pleased to submit the attached comments with respect to the low-income housing tax credit provisions contained in the Technical Corrections Act of 1987, S. 1350.

We commend you for including a number of provisions in the bill which will greatly improve the workability of the low-income housing tax credit. We deeply appreciate the time that you, your staff, and the staff of the Joint Committee on Taxation have taken to listen to the concerns which we have raised with respect to this new program. We know that you have a very genuine interest in assuring that the tax credit achieves its intended purpose -- to provide decent housing for those least able to afford it.

However, there are several provisions included in the bill which we believe could use some further refinement or about which we have deep concerns. In addition, there are several matters which were not addressed in the bill which we believe are necessary in order to resolve certain remaining problems with the tax credit. These matters are discussed in detail, together with a proposed solution with respect to each matter, in the attached comments. We would very much appreciate your consideration of these comments, and inclusion at the Committee's markup of amendments reflecting the proposed solutions.

Once again, thank you for responding to our concerns. We look forward to continuing to work with you and your staff as we go forward in the legislative process.

Very truly yours,

Association of Local Housing Finance Agencies

Coalition for Low and Moderate Income Housing

Council for Rural Housing and Development

Council of State Housing Agencies

Enterprise Foundation

National Association of Home Builders

National Corporation for Housing Partnerships

National Housing and Rehabilitation Association

National Housing Conference

National Leased Housing Association

National Low Income Housing Coalition

Rural Housing Services, Inc.

I. Carryover of Allocations

[Code Section 42(h)(6)(B); bill Section 102(1)(17)]

Issue: Section 42(h)(6)(B)(i) currently provides, in effect, that if a building is not completed and placed in service in the year with respect to which an allocation has been made, the allocation is lost -- both to the project and to the State. The technical corrections bill would permit carry-forwards of low-income tax credit allocations to the succeeding taxable year if the Secretary determines (1) that it was reasonable to believe that the building would be placed in service during the allocation calendar year and (2) that the delay was caused "solely" by "unforeseen conditions which were not within the control of the taxpayer." This amendment falls substantially short of what is needed to make the tax credit workable in a new construction or substantial rehabilitation context, and is considerably narrower than the rule contemplated at page 171 of the Blue Book.

The development of multifamily housing projects is uniquely vulnerable to delays resulting from material shortages, labor disputes, problems with contractors and subcontractors, weather, litigation, problems in obtaining construction or permanent financing, difficulties in obtaining bonding, zoning or other governmental approvals, etc. As a result, completion date projections for multifamily projects are highly speculative, and may easily be off by twelve months or more. Thus, it is routine to see developers which have two to three year financing commitments request extensions of those commitments because of delays. No developer can afford to risk the amount of money necessary to commence construction or rehabilitation of a housing project if any significant construction delay will result in the loss of the tax incentives for that project.

Although intended to address the question of delays, the technical amendment contemplated by Section 105(1)(17) is simply inadequate to solve the problem. It would require Treasury to determine, on a case-by-case basis, long after construction had begun, whether any delays were "unforeseen" and "not within the control of the taxpayer", and further, whether the initially anticipated completion date was "reasonable." With delays so common an occurrence in multifamily development, it is unreasonable to expect developers to risk their investments and housing credit agencies to risk the scarce allocations to their States in the hope that, if the anticipated completion date is not met, this heavy burden of proof, relying upon subjective criteria and generalized standards, can be met before the Treasury Department.

Proposed Solution: The Technical Amendments legislation should provide a safe harbor, permitting carryovers for buildings receiving allocations of low-income housing tax credits for years after 1987 where (1) at least 50 percent of total costs of a building have been expended by the end of the allocation year and (2) the project is placed in service no later than the close of the subsequent calendar year.

In addition, projects which do not meet the safe harbor timing and expenditure tests should be permitted to seek a determination that the construction delay has been caused by "reasons beyond the control of the taxpayer," which was the standard suggested by the Blue Book. This is a far more useful criterion, because it is based on an objective test, than the one proposed in section 102(1)(17) of the bill. However, contrary to the process outlined in the Technical Corrections bill as introduced, this determination should not be made by the Treasury Department, which has neither the manpower nor the experience to make detailed case-by-case reviews of construction, financing, and other delays, but rather, by the housing credit agency. Such an approach would help to strengthen the hand of the agencies in monitoring the development process, while not penalizing either the agencies or developers for delays which are genuinely beyond their control.

If carryovers are allowed only with respect to credits allocated after 1987, as provided in he bill, the budgetary impact of this safe harbor rule will be negligible while a substantial incentive will be provided for the development of new low-income projects.

II. Waiver of 10-Year Requirement for Federally-Assisted Projects

[Code Section 42(d)(6); bill Section 102(1)(7)]

Issue: Projects which have been placed in service within the preceding ten-year period are not eligible for the four percent credit with respect to acquisition costs. The Code provides an exception for certain Federally-assisted projects if a waiver is necessary to avoid an assignment of the mortgage to HUD or the Farmers Home Administration or to prevent a claim against a federal mortgage insurance fund or "by reason of other circumstances of financing distress". The bill deletes the quoted language, clearly precluding the availability of a waiver for a Federally-assigned project which is State-or locally-financed but whose mortgage is not Federally insured. Thus, this "technical correction" actually worsens the rules for the low-income housing credit and makes it unavailable as a tool for preserving nearly half of the older Federally-assisted low-income housing projects.

The preservation of the existing low-income housing stock is the most economical way of maintaining an adequate supply of housing for low-income tenants. Without additional incentives, such as the availability of the low-income housing tax credit, much of the existing low-income housing inventory will be lost either through conversions or abandonment, exacerbating housing shortgages for the very poorest Americans. Hundreds of thousands of units of Federally-assisted housing are reaching a point over the next several years at which conversions to non-low-income use will be permissible. The low-income tax credit can provide the incentive to preserve such projects for low-income tenants.

Proposed Solution: Instead of narrowing the availability of waivers,the statute should be broadened in several ways. First, waivers should be permitted for all distressed projects (including single family homes) which are either Federally-assisted, Federally-financed or Federally-insured or which have been acquired by the Federal government. This will provide broader protection for the Federal government in its mortgage insurance funds, and expand protection to all threatened Federally-assisted projects.

Second, the bill should provide that waivers will be granted automatically (i) upon the certification of HUD or FmHA that the necessary circumstances of distress exist, in the case of Federally-insured projects or projects which are Federally-assisted and not financed by a State or local housing agency, or (ii) upon the certification of the State or local housing finance agency in the case of Federally-assisted projects which are financed by such agency.

Third, the bill should retain the authorization currently in the Code to Treasury to grant waivers to Federally-assisted projects for reasons of "financial distress," and expand that authority, with respect to federally-assisted housing, to authorize waivers if, in the reasonable determination of HUD, the housing would otherwise be converted to non-low income use. Such a waiver would be helpful particularly in situations in which the housing is not distressed but is, in fact, a prime candidate for conversion to condominiums or market rate housing. The essential purpose of the waiver rule, to prevent "churning" of projects for tax advantage, can be achieved by requiring certification of financial distress or preservation as a precondition to the granting of a waiver and by restricting waivers under this authorization (but not under the exceptions treated in the preceding two paragraphs) to projects which have never received relief under Section 502 of the Tax Reform Act of 1986.

III. Clarify Rules regarding "35 - Partner" Elections

[Code Section 42(j)(5); bill Section 102(1)(22)]

Issue: The Code provides that a portion of the low-income housing tax credits taken in previous years may be recaptured if an investor disposes of his or her interest in a low-income housing project. The statute provides a special rule for partnerships consisting of 35 or more partners. Under that special rule, the partnership may elect to be treated as the "taxpayer" for purposes of recapture, as long as no more than 50% of the interests, calculated by value, are transferred within any 12-month period.

The original language of the Code [§42(j)(B)(i)] limited this special rule only to a partnership "which has 35 or more partners each of whom is a natural person or an estate . . . ." In response to concerns that a partnership that has any corporate partner would thereby not qualify, the bill would amend §42(j)(5)(B)(i) to read: "more than 1/2 the capital interests, and more than 1/2 the profit interests, in which are owned by a group of 35 more partners each of whom is a natural person or estate . . . ."

The requirement that more than 50% of the partnership be owned by natural persons does not serve any policy goal. The policy behind allowing partners in partnerships composed of more than 35 persons to transfer their interest without recapture was a recognition that, in these large partnerships, the partnership itself could insure that the property would remain as a low-income housing project. Basing qualification for this rule on an ongoing specified percentage of ownership by individuals, as opposed to corporations, would require large public partnerships, which may have thousands of partners, to calculate continuously their percentages of corporate ownership and individual ownership and would impose needless additional record-keeping burdens that would otherwise not occur.

Furthermore, another matter should be clarified. Many low-income housing investments are structured with two partnership tiers -- an "investment" and a "project" tier; this structure is well recognized and accepted by the Internal Revenue Service and is required by HUD and other governmental agencies in order to assure that each project is owned by a separate "project" tier entity. It is done in order to allow investors, who invest directly in the investment partnership, to hold an interest in several project partnerships. However, it is not clear that the investment partnership may make the 35-partner election, even if it has 35 individuals as partners, and it is not available to the project partnership which typically has only a general partner and the investment partnership as the sole limited partner.

Proposed Solution: A solution to the problem involving corporate ownership would be to require that the percentage ownership interests specified under the bill need be met only when the partnership makes the election to be treated as the taxpayer. In that manner, there would be assurance that the partnership was initially composed of individuals holding at least a 50% interest in the partnership, which information the partnership could compile without serious difficulty. It would eliminate the costly process of continuously monitoring ownership interests after investors were initially admitted to the partnership. As an alternative, the 50% ownership rule could be deleted altogether and the Code amended to specify that to be treated as the taxpayer, the partnership must be composed of "at least 35 partners who are natural persons or estates".

With respect to the availability of the election for investment partnerships in two-tier arrangements, the Code should specify that the election may be made by a partnership which holds a majority interest, directly or through another entity, in a qualified low-income housing project.

Once again, there is no revenue impact with this provision.

IV. Deep Rent Skewing

[Code Sections 42(g)(4) and 142(d)(4); bill Section 102(l)(14)]

Issue: Special provisions of the low-income housing tax credit have been enacted to facilitate the development of projects targeted to very low income tenants (at or below 40 percent of area median income). To qualify, at least 15 percent of the low-income units must be rented to such tenants and gross rents on the market rate units must be at least three times gross rents on the low-income units (the "three to one ratio"). The chief advantages of these special "deep rent skewing" provisions are that tenant income may rise as much as 70 percent (instead of 40 percent) above the applicable income ceiling before the tenant ceases to qualify as a low-income tenant, and once a qualified tenant's income exceeds the applicable limit, only the next available low-income unit must be rented to a new very low income tenant.

The bill clarifies that for the purpose of determining whether a project complies with the gross rent limitation applicable to deep rent skewed units under the low-income housing tax credit, Section 8 housing assistance payments and similar rental assistance payments are not counted. This is consistent with the treatment of Section 8 payments generally under the credit. (See section 42(g)(2)(i).) However, the bill specifically requires that for purposes of determining whether the three to one ratio is being satisfied, such rental assistance payments are counted.

The latter provision effectively makes the deep rent skewing option unavailable in tax credit projects generally, and completely frustrates the objective of the amendment. Deep rent skewing is only a practical option in areas with relatively high construction costs and rents. In such areas, however, units can be made available to the very low income target group only if additional subsidies, such as Section 8, are provided. The deep rent skewing option is sound public policy under those circumstances because it permits developers to build economically integrated projects where rents and the benefits of the tax credit are insufficient to support the construction and operation of very low income units without subsidies. It accomplishes this by allowing a project to avoid the drastic drop in income which would otherwise occur when a tenant in a subsidized Section 8 unit goes over income, requiring that the next available unit -- an unsubsidized unit -- be given to a low income tenant at the restricted rent level.

Congress' intent with respect to the three to one ratio and deep rent skewing is clearly expressed at page II-93 of the Conference Report on H.R. 3838, which says of the requirement: "the average rent charged to tenants in the residential rent units which are not low-income units is at least 300% of the <u>average rent charged</u> to low-income tenants for comparable units." (Emphasis supplied.) The proposed technical amendment, which focuses not on the rent charged to the tenant but rather the total of the tenant payment plus any subsidy payment for the unit, is explicitly contrary to this expression of intent and effectively vitiates the entire deep rent skewing provision. In addition, Congress' clear intent to facilitate the construction of housing for very low income tenants will be frustrated by disallowing the use of the very rental assistance which would make such targeting possible.

There are no revenue consequences to excluding rental assistance payments from tenant rents for purposes of determining whether a credit project meets the deep rent skewed definition.

<u>Proposed Solution</u>: The bill should be amended so as to make the treatment of Section 8 and similar rental assistance payment consistent in the deep rent skewing provisions. Such payments should be disregarded for purposes of determining whether the three to one ratio is satisfied.

V. <u>Infeasibility in Low Income Areas</u>

[Code Section 42(g); not addressed in bill]

<u>Issue</u>: In many low income rural areas, and in some urban areas, median income levels are so low that owners of housing projects attempting to utilize the low-income housing tax credit are finding such projects to be economically infeasible. This problem is caused by the requirement in Section 42(g) that ties a project's rents to the <u>area</u> median gross income. Even many projects assisted under the Farmers Home Administration Section 515 program, which subsidizes mortgage interest rates for rural projects to as low as one percent, are not workable because of severely low income levels. A random sample survey conducted by the Council for Rural Housing and Development of 12 geographically diverse states has shown that in those states the rent calculated under the credit program for rural projects was well below that needed for project operation and debt service. Thus, in anywhere from 18% to 95% of the counties in those states, the credit could not be used at all, even with the mortgage subsidy provided by FmHA. Although the survey did not cover other states, it is reasonable to assume that other states are experiencing the same problem and less formal feedback from other states does confirm that the problem is a widespread one in rural areas across the country, and a problem even in some low income urban areas.

A chart showing the results is attached.

Because many low income areas cannot support necessary rent levels, housing is not likely to be built in the areas where the need is most desperate -- the poorest areas of the country.

<u>Proposed Solution</u>: The simplest and fairest resolution of this issue, which would solve the problem in most parts of the country, is to allow the use of the higher of the statewide or the area median gross income in establishing income qualifications. Thus, in states which have statewide median incomes sufficient to provide necessary rent levels, particularly poor counties will not be left out of the program. This proposal has a precedent in the Internal Revenue Code: under the mortgage revenue bond program, income eligibility is determined in this manner [Code §143(f)(4)].

TAX CREDIT WORKABILITY

(RANDOM SAMPLE SURVEY -- INFORMATION ON OTHER STATES NOT READILY AVAILABLE)

STATE	Total # Counties	Unworkable Counties	Marginal Counties	Workable Counties
Arkansas	75	68	0	7
Georgia	107	68	15	24
Iowa	99	43	6	50
Kansas	101	54	21	26
Maine	20	19	1	0
Minnesota	87	44	--	--
Mississippi	79	24	2	3
Missouri	114	46	41	13
South Carolina	42	22	7	13
Tennessee	75	65	8	2
Texas	233	139	57	37
Virginia*	88	16	8	46

*17 Counties ineligible.

VI. <u>Eligible Basis - Placed in Service</u>

[Code Section 42(d)(5)(A); not addressed in bill]

<u>Issue</u>: Under Section 42(d)(5)(A), the eligible basis of any building for the entire 15 year compliance is determined on the date such building is placed in service.

A serious problem is created by this rule in that certain expenditures may be incurred by an owner of a newly constructed building after a project is opened for occupancy. For example, an owner may have opened certain units for occupancy on lower floors while continuing painting and carpeting on upper floors, or an owner may not have finished landscaping and parking areas when a project is being initially rented. If the eligible basis is fixed on the day the first unit is opened for occupancy, or even the date on which just a portion of a building is placed in service, the owner will lose a considerable amount of legitimate project costs from eligible basis.

Proposed Solution: The bill should specify that the eligible basis of a building is determined at the time that the building's qualified basis is determined. Under Code §42(f)(1), qualified basis is determined initially on the last day of the taxable year in which the building is placed in service, or if the taxpayer elects, on the last day of the succeeding taxable year. Tying the two determinations together makes logical sense and provides the owner with adequate time to complete the building. This rule would not change in any way the expenditures which can be taken into eligible basis; it would only alter the time such a determination is made. Because each state's allocation of credit authority is capped, there is no revenue loss associated with this provision.

VII. Acquisitions of Interests in Existing Buildings

[Code Section 42(d)(2) and 42(i)(5); not addressed in bill]

Issue: The Code specifies that in order to utilize the low-income housing tax credit with existing housing, the "building" must be acquired. An "existing building" is defined as one which is not "new." A problem is created in that prospective purchasers may wish to purchase all or virtually all of the partnership interests of a partnership owning an otherwise qualified building instead of buying the building itself. The parties may decide, for example, that the new purchasers will inherit certain liabilities or other assets associated with the partnership and their transaction will reflect these other matters. However, they might be precluded from structuring the transaction in this manner if they were required to acquire only the building itself.

If more than 50% of the partnership interests were transferred in any twelve month period, the partnership would be terminated for federal income tax purposes. Allowing a purchase of partnership interests instead of the real estate itself and further requiring that the resulting transaction be treated as a termination, would be a "placement in service" by the newly constituted partnership and thus could not be used to evade the ten-year last placed in service rule on existing properties under Section 42(d)(2)(B)(ii). Further, the Code specifies that the property may not be acquired from a related person, i.e., one who holds more than 10 percent of the partnership interests after the acquisition. Thus, a rule could be devised to assure that there would be no way to utilize this provision to avoid any other provisions in Section 42 or elsewhere in the Code.

Proposed Solution: Section 42(d)(2)(B)(i) should be amended by specifying that either a "building" or "not less than 90 percent of the interests of the partnership owning the building" could be acquired in order to meet the requirements of Section 42(d)(2)(A). By specifying a 90 percent threshold, there would be consistency with the related party provision prohibiting any existing partner from maintaining more than a 10 percent interest after the acquisition, and there would clearly be a tax termination and a new placement in service.

VIII. Impact of Investment Tax Credit At-Risk Provisions on Low-Income Housing Tax Credit

[Code Sections 42(k)(1) and 46(c)(8)(D)(ii)(I); not addressed in bill]

Issue: Section 42(k) of the Internal Revenue Code requires that rules similar to the rules in Section 46(c)(8) of the Code shall apply, in determining the qualified basis of a building for the purposes of the low-income housing tax credit, in the same manner as those rules apply in determining the credit base of property eligible for the investment tax credit. Under Section 46(c)(8), the amount of the credit that can be taken is significantly reduced under certain circumstances where the property has been financed with nonrecourse financing. In effect, the base, against which the amount of the credit is calculated, is reduced by the amount of the "nonqualified nonrecourse financing" outstanding with respect to the property at the end of the taxable year.

In applying this at-risk rule to the low-income housing credit, Congress wisely eliminated two requirements from Section 46(c)(8) -- that nonrecourse financing could not exceed 80% and that a commercial lender could not be related to the taxpayer. Furthermore, with respect to certain financing provided by certain nonprofit organizations, it eliminated the requirement that the lender be a commercial lender and that the property not have been acquired from the nonprofit lender. These exceptions recognized the fact that nonrecourse financing in excess of 80% is very common in connection with the development of low-income housing and that the imposition of such a requirement would have, in most instances, negated the usability of the low-income housing credit. The exceptions further recognized the unique circumstances surrounding the participation of nonprofit organizations in the acquisition or development of low-income rental housing.

While these exceptions will enable the low-income housing credit to be fully usable in some situations in which its usability would have been crippled by the unfettered application of Section 46(c)(8), there is another provision of Section 46(c)(8) which will severely hamper the availability of the credit for many other projects developed by profit-motivated persons and also for some projects being developed by nonprofit organizations. This is the provision which is contained in Section 46(c)(8)(D)(ii)(I) which would make nonrecourse financing "nonqualified", and thus reduce the credit base, if the property was acquired from a related person. We believe this was an unintentional consequence in the drafting of the bill.

It is not uncommon for the owner of a project, or one of its owners, to have also been the builder who erected or rehabilitated the project or in some other fashion to have provided some component of the property. If the person also owned more than a 10% interest in the property, either directly or through a partnership or closely held corporation, and the property was financed with nonrecourse financing in any amount, the at-risk provisions of Section 46(c)(8) would apply and make that nonrecourse financing "nonqualified". This result would take place even if the financing were from an unrelated third-party lender. Similarly, if the property is acquired from a nonprofit organization by a partnership in which that nonprofit organization retains a more than 10% interest (a circumstance otherwise contemplated and sanctioned by Section 42), the at-risk provisions of Section 46(c)(8) will apply if there exists nonrecourse financing to any extent.

<u>Proposed Solution</u>: The solution is a simple one. The bill should amend Code Section 42(k)(1) by eliminating the requirement in Section 46(c)(8)(D)(ii)(I) that the property be acquired from an unrelated person for purposes of determining the credit base for the low-income housing credit.

COMMENTS ON TECHNICAL CORRECTIONS
SUBMITTED BY

THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Sec. 111(m)(11). This provision would amend section 4979(f)(2) to provide that excess contributions and excess aggregate contributions distributed within two and a half months after the end of the plan year are taxed in the year the contributions were made, unless these amounts do not exceed $100, in which case they are to be taxed in the year of distribution. This amendment would create an additional burden on plan administrators, on participants who would be required to file amended returns and on the IRS, which would be required to process those returns. We do not believe that the alleged abuse -- deferral of income -- would be significant enough to add this complexity to the law. If such an abuse is nonetheless deemed substantial, we would suggest that all distributions of excess contributions and excess aggregate contributions be taxed in the year of distribution at the rate which would have been applicable in the year of contribution.

Sec. 111(h)(2). This provision makes it clear that plans are deemed to meet the nondiscrimination rules in section 410(b) of the Code if they have no nonhighly compensated employees. We believe a similar rule -- deeming plans in compliance with the section 401(k) nondiscrimination rules -- should apply to plans with no nonhighly compensated employees under section 401(k). However, staff of the IRS and the Treasury have suggested that plans which cover no nonhighly compensated employees will be unable to maintain a qualified cash or deferred arrangement under section 401(k). We believe that this result is not justified, especially in view of the $7000 dollar limitation on elective deferrals. We would request express statutory authorization that such arrangement automatically satisfy section 401(k)(3).

Sec. 111A(g). This provision would allow a spouse who is the beneficiary of all retirement distributions of a decedent to elect not to have the 15% excess distribution excise tax under sec. 4981(A) of the Code apply but instead, aggregate that distribution with the spouse's own retirement benefits and have the tax apply to the spouse. We believe this is an excellent rule but would propose that the bill permit the election of the spouse if he or she is either the direct beneficiary or the income beneficiary of a trust into which the decedent's distribution is made.

Sec. 111(c), (g), (h), and (n) and 111A(e). All of these provisions deal with the effective dates for collectively bargained plans. The bill makes it clear that the delayed effective dates apply to the entire plan and not only those employees who are collectively bargained in the plan. We believe the same rule should apply for COBRA purposes under the continuation coverage provision in section 162(k). The proposed Treasury regulations implementing COBRA would apply different effective dates to different benefit schedules in the same plan. The same rule which applies to the nondiscrimination rules in sec. 1112 of TRA '86 should apply to COBRA.

Sec. 111(d). The Joint Committtee's explanation provides that the section 401(a)(17) $200,000 cap on compensation taken into account is not indexed until 1990. This indexing was to begin in 1988 and it is unclear how the 1990 date was arrived at. We object to this delay, which will further create disparities in benefit plan arrangements outside the qualified plan area for employees.

Sec. 111(h)(9). This provision would statutorily validate the Treasury's interpretation of section 401(a)(26) of the Code relating to waiver of the excise tax on reversions in the event of plan termination of a plan which would fail the minimum participation rules. The restrictions on the interest rate that may be used to determine the accrued benefits result in a cutback of accrued benefits, which is inconsistent with the protections that accrued benefits received with respect to the section 415 changes in TRA '86. We believe that this provision, and the Treasury's interpretation, go too far.

Sec. 111B(a)(25). This provision would make the controlled group rules of Code section 414(t) applicable to COBRA retroactively. In light of the enormous sanction in COBRA -- the loss of an employer's entire deduction regardless of how small or technical the violation -- it is unacceptable and grossly unfair to apply the rules retroactively. We would strike paragraph (a)(25), the effective date provision from this section of the bill, learning the date of enactment of technical corrections as the effective date.

Sec. 111B(i). This provision would require that in order to be excepted from the 84-month rule in section 409 of the Code, a distribution from a paysop or trasop must be (1) a lump sum distribution, within the meaning of another technical corrections change to the distribution rules for section 401(k) plans and (2) there may be no successor plan established. Thus, the distribution must constitute the balance to the credit of the employee from all similar plans, thereby encouraging distributions from plans which might otherwise be retained for retirement purposes. In addition, it would appear to prohibit use of the exception to the 84-month rule if the funds are transferred in a plan to plan transfer or, as has been suggested, would prohibit a distribution if the employer maintains another defined contribution plan. We think these restrictions are inconsistent with the repeal of the tax credit for ESOPs and the purpose of the TRA '86 provision to allow an exception to the 84-month rule. It will make that exception virtually useless, and when used, will encourage the dissolution of pension plan funds, rather than their protection for retirement.

Sec. 111B would also make changes in the diversification requirements. We would suggest an additional change. We believe the effective date for the diversification requirements should be with respect to contributions made with respect to a plan year beginning after 12/31/86, rather than a contribution made after that date. Since many PAYSOPs will be "frozen", it is an unnecessary burden to require diversification only with respect to that small amount of stock contributed in 1987 for the 1986 plan year.

Sec. 111(c). This provision would add new paragraph 401(a)(29), requiring as a condition of qualification that plans provide that no elective deferral in excess of the limits in section 402(g) will be permitted in all plans maintained by the employer. We believe that when applied on a controlled group basis, this rule is unnecessarily harsh and susceptible to innocent mistakes which would result in an inappropriately harsh sanction. In addition, this provision would require a plan amendment prior to the date all other plan amendments stemming from TRA '86 will be required -- "plan years after 12/31/87" instead of the more appropriate "plan years after 12/31/88".

Sec. 111(j). This provision would require a plan to exclude participants from the definition of highly compensated employee under Code section 414(g) if he or she is a nonresident alien who receives no earned U.S. source income from the employer. We believe that since this rule is intended to be a rule of convenience for employers, it ought not to be mandatory but a permissive exclusion at the discretion of the employer.

Other Areas for Technical Corrections

TRA sec. 1131. The bill should exempt from the excise tax on nondeductible contributions those amounts which are contributed under ERISA Title IV to make a terminating defined benefit plan sufficient for benefits or to pay all of its withdrawal liability for a multiemployer plan. We believe these amounts should be deductible; however, failing that, they certainly should not draw an excise tax which would discourage responsible funding of benefits on termination of or withdrawal from plans.

COBRA

The Code Sanction. We believe the sanction imposed by COBRA is excessive and thus unenforceable. If Treasury regulations are to be believed, it is imposed for the smallest technical violation, even if promptly corrected, even if inadvertent, even if the employee is at fault. We believe that this sanction should be modified, and only applied when the violation is not corrected by the due date for the employer's tax return after the close of the plan year in which the violation occurred.

Due Date of Premiums. Sec. 162(k) provides that a qualified beneficiary must be permitted to pay premiums 30 days after the date due. The rule allows a substantially more permissive rule for qualified beneficiaries than for active employees who generally must pay their share of a premium before the coverage period begins, e.g., on the first of the month for that month of coverage. The current rule allows a qualified beneficiary to receive a month of coverage without paying the premium, and leaves the plan sponsor with a collection burden which we believe is excessive. We would recommend that a plan be permitted to impose a due date for premiums, that when coupled with a grace period, still precede the coverage period.

REA

Preretirement Survivor Annuity. Under Code section 417, a participant may not receive a preretirement survivor annuity, even with the consent of his or her spouse, until the participant reaches age 35 (or separates from service, if earlier). While sec. 118(q) of the bill clarifies the separation from service issue, we believe that this benefit should be waivable at any age.

Atlantic Union Conference of Seventh-day Adventists

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Telephone (617) 368-8333

July 8, 1987

Laura Wilcox
U. S. Senate Committee on Finance
S. D. 205
Washington, D. C. 20510

Dear Ms. Wilcox:

PLEASE AMEND the Technical Corrections Act of 1987 (H.R.2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m). Please consider the following: (1) gift annuities are used because an interested donor wants to make a gift to help our institution (2) gift annuities do not compete with commercial annuities and are not "commercial-type insurance": (3) failure to clarify the law would dry up an important source of funds for our organization's charitable activities; (4) gift annuities have been used by charitable organizations for over 100 years: and (5) for the small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501(m).

Please add your support to this amendment. Thank you very much.

Sincerely,

Dale C Beaulieu

Dale R. Beaulieu
Treasurer

n

TESTIMONY OF

ROBERT MASSIE

On behalf of:

The Authors Guild
Pen (Poets, Essayists and Novelists)
Writers Guild of America -- West
Washington Independent Writers

APPLICATION OF SECTION 263A
CAPITALIZATION RULES TO PROFESSIONAL AUTHORS

The Tax Reform Act of 1986 adopted uniform capitalization rules for costs of "producing tangible personal property". Capitalizing such costs generally is appropriate in matching expenses with related income items.

However, a footnote added to the Conference Explanation expanded the new capitalization requirement to include expenses of professional freelance authors. (This matter is not addressed in the statute, and was not considered by either the House or the Senate.) Under this new requirement, authors will be required to allocate every expense they incur among each of their pending projects; and then to amortize such costs over the projected recovery life of the projects. (Thus, authors who are researching and writing books, while supporting themselves from writing magazine articles, etc., could not deduct their expenses for that book against income from their other writing projects.)

The required allocations and projections of useful lives for each project will be far more complex and uncertain than even the capitalization requirements applicable to manufacturers. As applied to authors, the new capitalization requirements effectively will represent pure guesswork.

The new expense allocation and amortization rules single out writers from all other professionals who provide services (e.g., lawyers that work on contingent fee arrangements), and provide extremely harsh treatment by denying deductions for all current expenses. The treatment of authors' manuscripts as tangible property also runs directly counter to the rule of Section 1221(3) of the Internal Revenue Code -- which denies capital asset status for authors' work products.

Prior law permitted professional authors to deduct their current expenses, just as architects, attorneys and others do. In fact, when the IRS attempted previously to apply capitalization rules adopted to deal with book and movie tax shelters to authors, the Second Circuit Court of Appeals rejected the IRS' view, stating that the compliance problems would be "immense".

The new rules will entail significant recordkeeping burdens, and likely will result in many controversies between IRS and taxpayers. (It has been suggested that every author maintain a log of time spent on each project in order to apply these new rules!) If a project is not successful, authors will have to abandon their copyright protection in order to deduct their expenses -- surely a questionable policy.

Since authors as a group generally have very modest earnings (median income from writing is $7,900 per year), these burdensome new rules will have little revenue effect. Although it is appropriate to apply capitalization requirements to manufacturers, publishers, etc., there is no justification for extending these complex and uncertain requirements to authors.

MEMORANDUM REGARDING THE NEED FOR A TECHNICAL CORRECTION TO SECTION 263A TO EXCLUDE PROFESSIONAL WRITERS' RESEARCH AND WRITING EXPENSES FROM THE UNIFORM CAPITALIZATION RULES

This memorandum is submitted by The Authors Guild, Inc. regarding the need for a technical correction to the Tax Reform Act of 1986 (the "Act") to exclude from the uniform capitalization rules the research and writing expenses of professional authors. Such an amendment is necessary because of the undue burden that application of these complex and uncertain rules will impose on professional writers -- a burden that, it is submitted, is wholly disproportionate to any governmental interest in the application of the capitalization requirements in this setting. Stated simply, the rules of Section 263A as they apply to authors' expenses are virtually unworkable; and their application to a group of individuals who in general derive only modest income from writing is completely at variance with sound tax policy. The amendment is further justified to prevent the discriminatory application of Section 263A to only a single group of persons that derives income from services.

Background

The uniform capitalization rules contained in Section 263A of the Internal Revenue Code of 1986 were enacted because:

> "The Congress believed that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome."[1]

In general, the capitalization of such costs is in furtherance of the basic tax accounting objective of matching income and related expense items.

Prior to adoption of the Act, the ordinary and necessary business expenses of professional authors were deductible when paid under Section 162.[2] Although the Internal Revenue Service contended that former Section 280 (enacted in 1976 to require capitalization of expenses relating to production of films, books, records, etc.) barred the deduction of authors' research and writing expenses, that assertion was rejected by the Court of Appeals for the Second Circuit, which held that the intended reach of that section was tax shelter operations and book publishers, rather than authors.[3]

1 Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 508-09 (1987).

2 No assertion is made that expenses associated with writing activity that fails to satisfy the "hobby loss" provisions of Section 183 are, or should be, deductible under Section 162.

3 See Hadley v. Commissioner, 819 F.2d 359 (2d Cir. 1987), rev'g 86 T.C. 764 (1986) and 51 T.C.M. 948 (1986). Former Section 280 required capitalization of amounts attributable to the "production of a . . . book . . . ." Section 280(a), as in effect prior to the Tax Reform Act of 1986.

The possibility that the Act's uniform capitalization rules might apply to the research and writing expenses of authors first emerged in the Conference Explanation of the Act. The treatment of authors' expenses is not addressed in new Section 263A itself, or in the House or Senate bills or accompanying reports. Moreover, it is entirely plausible to read new Section 263A, like former Section 280, to be altogether inapplicable to authors' research and writing expenses.[4]

Nonetheless, the following sentences appeared in a footnote in the Conference Explanation of the Act:

> "For this purpose, tangible property includes films, sound recordings, video tapes, books, and other similarly [sic] property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book.[5]

4 In relevant part, Section 263A applies to the "production" of "tangible personal property." Section 263A(b)(1). The term "produce" is defined for this purpose to include "construct, build, install, manufacture, develop, or improve." Section 263A(g)(1). Only through a strained reading of these words could the act of writing a manuscript be included among the targeted activities. Moreover, while the statute defines "tangible personal property" to include a "book" (Section 263A(b) flush language), the logical effect of that provision would seem to be to subject the manufacturer of the book (e.g., the publisher, binder, printer, etc.) to the new rules, rather than the author of the manuscript that underlies the book to be published. The similarity of the structure of Section 263A and former Section 280 underscores the argument that neither section is applicable to authors.

5 H. Rep. No. 99-841, 99th Cong., 2d Sess. II-308 n.1 (1986) (emphasis added).

The Authors Guild, Inc. respectfully submits that the purported reversal of prior law by means of the footnote just quoted does not represent sound tax policy, and should expressly be rejected through an amendment in the Technical Corrections bill.

Operation of Section 263A
as It Applies to Authors

The burden that will be imposed on authors by application of the uniform capitalization rules can without exaggeration be characterized as extraordinary.

The general requirement of Section 263A in the present context is that all expenses allocable to writing activities that otherwise would be deductible under Section 162 must instead be capitalized to the account of the project in question. Such expenses then are recoverable as income is derived from the project, based on total revenues expected to be derived from the project.

The first step in the application of this rule requires fragmentation of all writing-related expenses across the writer's affected projects.[6] In a typical situation, a writer may be involved in writing a book, writing one or more articles, and perhaps working on certain re-allocate the expenses that, not uncommonly, might be attributable in part to each of these projects? Although Treasury Regulations have been issued under Section 263A, no answer to this question is suggested. General tax principles would call for an allocation based on the relative fair market values of the projects, which presumably would be derived by discounting to present value the cash flows projected for each of the writing projects -- obviously a highly uncertain exercise as an author embarks upon the preparation of a manuscript.

In an effort to simplify the resolution of this cost allocation issue, it has been suggested by government staff that the author keep records of the time spent on each project, and allocate expenses -- presumably other than those specifically allocable to a given project -- on the basis of relative time spent. One might wonder whether the tax

6 Such expense might include telephone, freelance typist, utilities, cost of periodicals and the like.

law should demand that the Nation's writers log their time spent on each poem, short story and essay in order to meet the requirements of Section 263A. In all events, however, keeping such time logs still will fail to produce the needed data where time is spent in a manner (e.g., research) that might benefit multiple projects.

Following on the exercise of allocating the writer's expenses to each of the projects in process, the question then to be addressed is the manner in which the capitalized costs may be recovered. We understand the applicable principles to be the following:[7]

(i) In general, the "income forecast" method must be used to determine the deductible portion of capitalized expenses by reference to the ratio of (x) annual revenues derived from the project to (y) total expected revenues for the project.

(ii) Annual re-assessments of the total expected revenues are required to be made.

(iii) In any years in which no income is earned from the project, no deduction may be claimed.

(iv) Even if the project proves a failure, no deduction may be claimed unless the project is shown to have been abandoned.

Again, the theory that underlies the required analysis is not in question. The reality, however, is that any meaningful estimate of the projected royalties from a book or article will often be largely guesswork.[8] For example, what of the poem that is first printed in a magazine, later is collected in a volume of the author's poems, and still later is aggregated as part of the author's collected works? As

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7 Rev. Rul. 60-358, 1960-2 C.B. 68.

8 The Court of Appeals for the Second Circuit characterized the attempt to apply the income forecast method to authors' expenses in Hadley, supra, as follows:

> "In an activity as ephemeral as writing a book, the difficulties in estimating a future income stream and determining the time of ultimate write-off when it becomes clear that either a book will not be published or, if published, will not sell, appear immense."

another example, if poet A has had several poems anthologized, should poet B assume that his first poem published in the New Yorker also will one day appear in an anthology? Obviously, without information as to the expected pattern of publication, no meaningful estimate of future income can be derived. More fundamentally, even authors with a solid track record of publication at times find that later books do not sell well. The converse is also true. If it is not abundantly clear, these rules are unadministrable, and do not work.[9]

A final point regarding operation of the rules. Suppose a given project is a failure; when (if ever) may the taxpayer deduct the capitalized expenses? It has been suggested by government staff that the taxpayer must abandon his or her entire right in the project to qualify for a deduction. Presumably, that will require abandoning the author's copyright protection -- so that the work will become part of the public domain. Without debating the technical tax aspects of such a rule, from a public policy viewpoint such a requirement is most charitably characterized as unfortunate.

Compliance and Administration Issues

Each of the above fact-intensive issues will, of course, be subject to review by the Internal Revenue Service, with the ultimate resolution being time-consuming and expensive for both taxpayers and government. More fundamentally, this new system based largely on guesswork and surmise is certain to prove a source of taxpayer compliance difficulties. One would have thought that the government would strongly disfavor rules that will encourage aggressive position-taking based on the highly subjective matters such as those involved here.[10]

The merits of attempting, in any context, to provide a "matching" rule based upon such elusive matters as the required allocation of authors' costs, and the revenue estimated to be derived from projects, might fairly be debated. Whatever value the change might

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9 That is not to say that the income forecast method can never produce appropriate results. In the context of a movie company, or publishing house, the volume of amortizable films or books should yield reasonable results due to an averaging process. An individual author -- who may produce a major work only once in several years -- obviously has no such benefit of an averaging phenomenon.

possess in the abstract, however, is completely swallowed up by the administrative and practical difficulties that will be faced by the group affected by this change. Virtually all of the affected taxpayers are individuals. It may be speculated that many prepare their tax returns without professional assistance. For these persons, it simply is the case that the tax law will be incomprehensible. These persons then will have the choice of incurring the expense of retaining a professional return preparer, or, in many cases, of failing to comply with the law. It is defensible to impose sophisticated tax accounting concepts to more accurately measure income on taxpayers who ordinarily employ such concepts in their business. It is totally indefensible to impose rules fraught with interpretive difficulty on persons who will frequently be without means to understand or deal with such rules.

Writers vs. Other Service Providers

Authors are not alone among service-providers in incurring expenses in advance of related receipts.[11] A lawyer may work for years on a case, particularly where a contingent fee is involved, and be permitted to deduct expenses when paid, far in advance of receipt of any fee income. Similarly, an architect may work on a set of plans for a building over multiple years, and deduct expenses well in advance of payment for the services.

There is no apparent basis for providing discriminatory treatment for authors in relation to other service providers. As the language of Section 263A clearly states, it is intended to reach persons that produce tangible property -- i.e., property other than a lawyer's

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10 One need only examine the numerous factual-issue cases that fill the Tax Court docket, or the various recent Code penalty provisions relating to valuation (e.g., the Section 6659 and 6660 valuation overstatement and understatement penalties) to confirm the difficult problem of tax administration that arises from the presence of factual issues in the tax law.

11 Commentators have observed that authors are properly characterized as receiving income from the sale of services, rather than from production of an asset. Note, Tax Treatment of Prepublication Expenses of Authors and Publishers, 82 Mich. L. Rev. 537 (1983). See also Hadley, supra.

brief or an architect's plans and specifications. Any decision by the Congress to extend the reach of Section 263A to the expenses of service providers should be deliberate and uniform.

Revenue Implications

Although one can only speculate as to the amount of revenue that will be produced by this change in the tax treatment of authors' expenses, available information indicates that the amounts involved are small, if not trivial. Initially, it must be borne in mind that the issue is not the allowability vel non of deductions: the issue is any revenue loss resulting from deferral of tax collections. Two observations are appropriate:—one, the group in question, professional writers, have extremely modest earnings; median income from writing is estimated to be $6,900 per year. Second, an exception to the uniform capitalization rules for such persons is not a loophole that might be exploited by the ingenious in order to gain an unintended advantage.

Conclusion

An exception should be provided to Section 263A for the research and writing expenses of professional authors.

The Authors Guild, Inc.

July 17, 1987

MEMORANDUM REGARDING THE NEED FOR A TECHNICAL CORRECTION TO SECTION 263A TO EXCLUDE PROFESSIONAL WRITERS' RESEARCH AND WRITING EXPENSES FROM THE UNIFORM CAPITALIZATION RULES

This memorandum is submitted by The Authors Guild, Inc. regarding the need for a technical correction to the Tax Reform Act of 1986 (the "Act") to exclude from the uniform capitalization rules the research and writing expenses of professional authors. Such an amendment is necessary because of the undue burden that application of these complex and uncertain rules will impose on professional writers -- a burden that, it is submitted, is wholly disproportionate to any governmental interest in the application of the capitalization requirements in this setting. Stated simply, the rules of Section 263A as they apply to authors' expenses are virtually unworkable; and their application to a group of individuals who in general derive only modest income from writing is completely at variance with sound tax policy. The amendment is further justified to prevent the discriminatory application of Section 263A to only a single group of persons that derives income from

Background

The uniform capitalization rules contained in Section 263A of the Internal Revenue Code of 1986 were enacted because:

> "The Congress believed that, in order to more accurately reflect income and make the income tax system more neutral, a single, comprehensive set of rules should govern the capitalization of costs of producing, acquiring, and holding property, including interest expense, subject to appropriate exceptions where application of the rules might be unduly burdensome."[1]

In general, the capitalization of such costs is in furtherance of the basic tax accounting objective of matching income and related expense items.

Prior to adoption of the Act, the ordinary and necessary business expenses of professional authors were deductible when paid under Section 162.[2] Although the Internal Revenue Service contended that former Section 280 (enacted in 1976 to require capitalization of expenses relating to production of films, books, records, etc.) barred the deduction of authors' research and writing expenses, that assertion was rejected by the Court of Appeals for the Second Circuit, which held that the intended reach of that section was tax shelter operations and book publishers, rather than authors.[3]

The possibility that the Act's uniform capitalization rules might apply to the research and writing expenses of authors first emerged in the Conference Explanation of the Act. The treatment of authors' expenses is not addressed in new Section 263A itself, or in the House or Senate bills or accompanying reports. Moreover, it is entirely plausible to read new Section 263A, like former Section 280, to be altogether inapplicable to authors' research and writing expenses.[4]

Nonetheless, the following sentences appeared in a footnote in the Conference Explanation of the Act:

> "For this purpose, tangible property includes films, sound recordings, video tapes, books, and other similarly [sic] property embodying words, ideas, concepts, images, or sounds, by the creator thereof. Thus, for example, the uniform capitalization rules apply to the costs of producing a motion picture or researching and writing a book.[5]

The Authors Guild, Inc. respectfully submits that the purported reversal of prior law by means of the footnote just quoted does not represent sound tax policy, and should expressly be rejected through an amendment in the Technical Corrections bill.

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as It Applies to Authors

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Compliance and Administration Issues

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The merits of attempting, in any context, to provide a "matching" rule based upon such elusive matters as the required allocation of authors' costs, and the revenue estimated to be derived from projects, might fairly be debated. Whatever value the change might possess in the abstract, however, is completely swallowed up by the administrative and practical difficulties that will be faced by the group affected by this change. Virtually all of the affected taxpayers are individuals. It may be speculated that many prepare their tax returns without professional assistance. For these persons, it simply is the case that the tax law will be incomprehensible. These persons then will have the choice of incurring the expense of retaining a professional return preparer, or, in many cases, of failing to comply with the law. It is defensible to impose sophisticated tax accounting concepts to more accurately measure income on taxpayers who ordinarily employ such concepts in their business. It is totally indefensible to impose rules fraught with interpretive difficulty on persons who will frequently be without means to understand or deal with such rules.

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An exception should be provided to Section 263A for the research and writing expenses of professional authors.

The Authors Guild, Inc.

1 Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986 508-09 (1987).

2 No assertion is made that expenses associated with writing activity that fails to satisfy the "hobby loss" provisions of Section 183 are, or should be, deductible under Section 162.

3 See Hadley v. Commissioner, 819 F.2d 359 (2d Cir. 1987), rev'g 86 T.C. 764 (1986) and 51 T.C.M. 948 (1986). Former Section 280 required capitalization of amounts attributable to the "production of a . . . book . . . ." Section 280(a), as in effect prior to the Tax Reform Act of 1986.

4 In relevant part, Section 263A applies to the "production" of "tangible personal property." Section 263A(b)(1). The term "produce" is defined for this purpose to include "construct, build, install, manufacture, develop, or improve." Section 263A(g)(1). Only through a strained reading of these words could the act of writing a manuscript be included among the targeted activities. Moreover, while the statute defines "tangible personal property" to include a "book" (Section 263A(b) flush language), the logical effect of that provision would seem to be to subject the manufacturer of the book (e.g., the publisher, binder, printer, etc.) to the new rules, rather than the author of the manuscript that underlies the book to be published. The similarity of the structure of Section 263A and former Section 280 underscores the argument that neither section is applicable to authors.

5 H. Rep. No. 99-841, 99th Cong., 2d Sess. II-308 n.1 (1986) (emphasis added).

6 Such expense might include telephone, freelance typist, utilities, cost of periodicals and the like.

7 Rev. Rul. 60-358, 1960-2 C.B. 68.

8 The Court of Appeals for the Second Circuit characterized the attempt to apply the income forecast method to authors' expenses in Hadley, supra, as follows:

> "In an activity as ephemeral as writing a book, the difficulties in estimating a future income stream and determining the time of ultimate write-off when it becomes clear that either a book will not be published or, if published, will not sell, appear immense."

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KATHERINE AUSTIN
1706 OLIVER AVE.
SAN DIEGO, CA 92109
(619) 270-7777

September 2, 1987

The Stnate Finance Committee
Laura Wilcox, Hearing Clerk
SDOB 205
Washington, D.C. 20510

Dear Committee Members:

The TRA-86 section of the 1986 Tax Reform Act is not fair to writers, especially unpublished ones. I want to officially protest this section of the act. Should it pass I will not be able to continue with my chosen career of writing fiction because I will not be able to deduct my expenses proportionally to my income.

Lumping writers together with manufacturers and forcing us to follow the rules of capitalization to deduct our writing expenses is crippling and unrealistic.

Please don't let this nation lose a valuable resource because of an oversight in the structuring of the tax laws.

Please vote that this section, TRA-86 not be passed as is.

Thank you for your attention.

Yours truly,

Katherine Austin

Katherine Austin

Banco Popular de Puerto Rico

HECTOR LEDESMA
VICE CHAIRMAN
BOARD OF DIRECTORS

July 15, 1987

Hon. Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
205 Dirkson Bldg.
Washington, D. C. 20510

Dear Mr. Chairman:

I am pleased to respond to your request for comments on the Technical Corrections Bill(S.1350)by bringing to the attention of the Committee a matter that is of major significance to Puerto Rican banks.

As a consequence of successive amendments to the Internal Revenue Code a special provision, Section 882(e)originally enacted as a benefit to Puerto Rican banks, now operates adversely to their interest. The Puerto Rican banks are taxed on U. S. Government obligations while other non-U.S. banks are not taxed on such obligations. This anomaly results from the following legislative sequence:

1. Generally, banks organized in Puerto Rico are taxed as foreign banks under the Internal Revenue Code. As regulated members of the Federal Reserve System, Puerto Rican banks as in the case of U. S. Mainland banks, meet reserve requirements by investments in U. S. government obligations. The banks incur interest expense on the funds they borrow to obtain the reserve assets. The problem relates to the interest received by the Puerto Rican banks on the U. S. government obligations held to meet the reserve requirements.

2. Prior to 1966, the interest received by Puerto Rican banks on government obligations(as in the case of such payments to other foreign banks)was subject to a 30 percent tax on the gross interest payment. This 30 percent tax made the investments uneconomic since the withholding tax was greater than the net income. Section 882(e)was enacted in 1966, so that U. S. tax would be imposed on a net basis for income from U. S. government obligations received by possession banks. This was achieved by deeming such income to be effectively connected with a U. S. trade or business and therefore taxable by the U. S. on a net income basis after deducting their interest expense. Thus, the 30 percent tax no longer applied.

3. In 1984, the Congress allowed S. Government obligations held by foreign persons to be mpt from the 30 percent or other U. S. tax. This exemption did not apply to Puerto Rican banks because section 882(e)was not changed; therefore, U. S. government obligations held by Puerto Rican banks continued to be taxable by the U. S.

4. The 1986 Tax Reform Act added a substantial additional tax-a branch profits tax-that applies to non-U. s. corporations that have effectively connected U. S. income. Since section 882(e)deems income from U. S. Government obligations to be effectively connected, Puerto Rican banks will pay not only

the U. S. corporate tax on such income, but an additional branch tax liability. The total U. S. tax(corporate tax plus branch tax)is projected to generate losses on Puerto Rican banks' investments in U. S. government obligations.

The details of this sequence of events are set forth in an accompanying memorandum.

As a result, non-U. S. banks, other than Puerto Rican banks, can now hold qualifying U. S. Treasury securities free of any U. S corporate or withholding tax, while Puerto Rican banks, which hold such investments under banking requirements, are subject both to the U. S. corporate tax and the branch level tax on income from such investments. This result is based solely on the special rule(initially designed to be a benefit for Puerto Rican banks)that their interest income on U. S. obligations is deemed effectively connected income. In view of the evolution of the basic U. S. rules, what was once a benefit is now a serious penalty.

Puerto Rican banks, therefore, should not continue to be subject to the mandatory rule of section 882(e)deeming any interest received by them on U. S. government obligations to be effectively connected income since other non-U. S. banks are not subject to such taxation.

The deemed effectively connected income rule should be eliminated with rules to permit an orderly transition. This would have the effect of treating Puerto Rican banks in a similar manner as other non-U. S. banks.

This letter is written on behalf of a consortium comprised by Banco Popular de Puerto Rico, Banco de Ponce, Banco Central Corporation, and several other Puerto Rican banks.

Very truly yours,

HL/rfg
Enclosure

Memorandum Re: Technical Corrections Required to Remedy Unintended Adverse Effects of the Tax Reform Act of 1986 on Puerto Rican Banks

Banks organized in Puerto Rico are being very adversely affected by apparently unintended results of the new branch level tax rules and other changes enacted as part of the Tax Reform Act of 1986. The combined effect of the 1986 and 1984 Reform Acts results in a discriminatory tax impact against Puerto Rican banks when compared to the tax treatment of other similarly situated foreign banks and foreign investors. The problem can be solved by a simple technical correction. This memorandum will describe the nature of the problem and the legislative remedy which is proposed.

BACKGROUND OF THE PROBLEM

For U.S. tax purposes, corporations organized in Puerto Rico are treated as foreign corporations. Foreign corporations which earn U.S. source investment income not effectively connected with the conduct of a trade or business in the U.S. are generally subject to a 30% flat-rate tax on the gross amount of this income. The tax, which is imposed by Section 881(a) of the Internal Revenue Code, is collected by requiring U.S. payers to withold it from payments to foreign corporations at the 30% rate or at a lower treaty rate, if applicable.

In the early 1960's, Puerto Rican banks pointed out to Congress that although they were treated as foreign corporations for tax purposes, they were also subject to U.S. banking regulations. Under those regulations, banks organized in Puerto Rico and other U.S. possessions are effectively required to hold large portfolios of U.S. government obligations to meet reserve requirements. Since the banks pay interest on the funds they borrow to acquire the U.S. government obligations, the 30% withholding tax on gross interest income from those obligations resulted in an unfairly high effective tax rate.

In response to this inequity, Congress included a relief provision in the Foreign Investors Tax Act of 1966. That provision, which was enacted as Section 882(e) of the Internal Revenue Code, provides that interest on U.S. government obligations received by banks organized in a U.S. possession shall be <u>treated as</u> income effectively connected with the conduct of a U.S. trade or business, regardless of whether it is <u>in fact</u> effectively connected. Accordingly, the interest which possession banks receive on U.S. government obligations is not subject to the 30% flat-rate tax on gross income, but instead is taxed at the regular corporate rates after allowance of deductions for expenses, including interest costs, regardless of whether or not the possession bank is engaged in a trade or business in the United States. The effect of this amendment was to permit Purto Rican banks their continued investment in U.S. government obligations without being exposed to the 30% gross income tax as the situation otherwise required for other foreign investors.

The 1966 amendment provided very necessary relief for possessions banks until 1984. By that year, Congress had grown concerned that the 30% withholding tax on investment interest paid to foreign investors had become a major impediment to the ability of U.S. coporations and the U.S. government to borrow abroad. To remove that obstacle, Congress included in the Tax Reform Act of 1984 a provision codified as Section 881(c) repealing the 30% withholding tax on interest paid on certain U.S. portfolio investments to foreign corporations and nonresident alien individuals. As a result, foreign banks not located in U.S. possessions and not engaged in a trade or business in the U.S. are now entirely exempt from U.S. income tax on interest earned on qualifying portfolio investments in U.S. corporate and government obligations. Foreign banks that are actually doing business in the United States may also invoke the portfolio interest exception if the income is not "effectively connected" with a U.S. trade or business.

Banks organized in U.S. possessions are also generally eligible to avail themselves of the exemption from tax on interest from U.S. portfolio investments. However, in amending the withholding tax provisions of Code Section 881(c), Congress apparently overlooked making a corresponding amendment to Code Section 882(e), which contains the special rule for interest paid on U.S. government obligations to possessions banks. As a result, the possession banks are still required to treat all income from U.S. government obligations as effectively connected with a U.S. trade or business and pay the tax on any net income resulting therefrom - even though the income may not in fact be connected with a U.S. trade or business. Thus, a provision (Section 882(e)) originally added to the Internal Revenue Code as a relief measure for possessions banks not only became unnecessary following the 1984 legislation, but actually placed them in a position of disadvantage in comparison with other foreign investors.

THE CURRENT PROBLEM

Certain changes made by the Tax Reform Act of 1986 will further aggravate the effect of continued applicability of Section 882(e). When the 1986 amendments are combined with the portfolio interest changes introduced in 1984 without a corresponding amendment to Section 882(e), the difference in tax treatment of Puerto Rican banks reaches a serious degree of discrimination when compared to other foreign banks. These problems are discussed in the paragraphs which follow.

. Branch level tax on interest

Section 884(f), enacted by the Tax Reform Act of 1986, requires foreign corporations to pay a 30% tax on the amount by which the interest expense claimed as a deduction in the federal income tax return exceeds the interest actually paid by the United States branch of the foreign corporation. Foreign banks filing federal income tax returns are required to compute the allowable interest deduction in accordance with a formula prescribed by Regulations Section 1.882-5. In general terms, the interest deduction determined in accordance with this regulatory provision depends on the amount of assets that generate "effectively connected income." By definition, U.S. government obligations owned by Puert Rican banks are "effectively connected assets" because of Section 882(e), and thereby attract to the federal return an interest expense deduction in excess of what is paid by the U.S. branch. The interest so determined is actually attributable to and is paid by the bank's non U.S. operations.

The effect of Section 884(f) is that it will require the possession banks to apply a branch level tax at the rate of 30% on the amount of interest expense paid by the bank which is allocated to the interest income from U.S. government obligations and claimed as a deduction against such income in the federal income tax return. In the usual case, this tax will far exceed the profit "spread" earned from the investments, and to a large extent will place the banks back in the same position they were in before Section 882(e) was enacted for relief in 1966. Other foreign banks are not so similarly treated.

. Branch profits tax

In addition to the branch level tax on excess interest deductions allocable to income from U.S. government obligations, Section 884 will generally impose a 30% tax on the net earnings of foreign corporations required to be reported in the federal tax return, to the extent such earnings are deemed not to be reinvested in the U.S. This is the equivalent of the 30% withholding tax which is generally imposed upon dividends paid from a U.S. subsidiary to a foreign stockholder.

The starting point in determining whether a foreign corporation will be subject to the branch profit tax is the concept of "effectively connected earnigns and profits" for the taxable year. In the case of Puerto Rican banks, this term includes, because of Section 882(e), the interest generated from U.S. government obligations. The effect of Section 884 is that Puerto Rican banks will be exposed to this additional tax on the net earnings attributable to their investments in U.S. government obligations, at such time as these earnings are considered under the rule as having been repatriated from the U.S. It should also be observed that Puerto Rican Banks not engaged in a U.S. branch operation are technically exposed to the branch profit tax because the interest earned on the U.S. obligations is considered as "effectively connected earnings and profits." Other foreign banks will be subject to the branch profit tax only to the extent of earnings generated and attributable to an actual branch operation being conducted in the United States.

. <u>Dividend sourcing rule</u>

Another change made by the Tax Reform Act of 1986 which may bring about unintended results due to the continuation of Section 882(e) is the amendment to Section 861(a)(2)(B), the sourcing rule for dividends from foreign corporations. The rule now provides that dividends received from a foreign corporation will be considered all or in part as U.S. source income if 25% or more of the corporation's gross income from all sources for the preceding 3-year period was effectively connected (or treated as effectively connected) with the conduct of a trade or business in the U.S. The Tax Reform Act of 1986 reduced the percentage threshold in this rule to the present 25% from 50%.

This rule is very significant for stockholders who are U.S. citizens residing in Puerto Rico, in that they are exempt under Section 933 from federal income tax on all income from

Puerto Rican sources (instead, Puerto Rico residents are taxable on such income in Puerto Rico). The rule is also significant for other U.S. persons, for whom the result of the sourcing rule will determine whether they are entitled to relief from double taxation on the income through the foreign tax credit mechanism (dividends paid by Puerto Rican corporations to nonresidents of Puerto Rico are generally subject to Puerto Rican withholding taxes).

The continuing requirement of Section 882(e) that the Puerto Rican banks treat all income from U.S. government obligations as effectively connected income may bring some of these banks dangerously close to the new 25% threshold in the income sourcing rule. Dividends from foreign corporations which are not subject to Section 882(e) are not so jeopardized.

SUMMARY OF THE PROBLEM

In summary, as a result of apparently unforeseen consequences of the tax legislation in 1984 and 1986, Section 882(e) now has the following adverse effects:

1. Possession banks are exposed to federal taxes on the taxable income generated by investments in U.S. government obligations, which are not in fact connected with a U.S. trade or business, while other foreign investors making similar investments may enjoy complete exemption from federal income taxes.

2. It exposes the possession banks to the 30% branch level tax on interest expenses allocable to the income generated by these investments, a tax which will invariably far exceed the net income actually generated from the investments, while other foreign investors will be subject to these rules only in connection with income actually generated by the U.S. trade or business.

3. It exposes the Puerto Rican banks to the new 30% branch profits tax to the extent the net earnings from U.S. government obligations not related to the U.S. trade or business are deemed to have been repatriated from the U.S., while other foreign investors will be subject to these rules only in connection with income actually generated by the U.S. trade or business.

4. It exposes stockholders of the Puerto Rican banks to increased risk that all or part of their dividends from the banks will be treated, unjustifiably we believe, as U.S. source income possibly subject to double taxation.

The effects of the first three items can be seen in the accompanying illustration.

PROPOSED TECHNICAL CORRECTIONS

Unlike banks in Guam and certain other U.S. possessions, which are spared some of these federal tax problems by specific exceptions favoring those jurisdictions only (Sections 881(b) and 882(e)), the banks organized in Puerto Rico are alone in having to seek a legislative remedy.

It is evident that all of the above-cited problems are the result of the continued existence of the requirement under Section 882(e) that the possession banks treat all income from U.S. government obligations as U.S. effectively connected income, even where such income is not in fact so connected. This rule was rendered unnecessary by the 1984 legislation repealing the 30% tax on U.S. portfolio debt investments by foreigners, and was rendered altogether inappropriate by the interaction of changes made by the 1986 legislation.

The most expeditious solution to all of these problems will be to include the following provision in the technical corrections bill currently being drafted:

o Amend Section 882(e) to provide the possession banks with an election not to have this provision apply at all, effective for taxable years beginning after December 31, 1986.

This amendment would be the most straightforward remedy and would resolve all of the problems cited above. However, it should be anticipated that for some banks, the immediate shifts which may be necessary in their U.S. government investment portfolios to comply with the conditions of the portfolio debt investment rule will be imprudent from an investment standpoint (e.g., all U.S. government obligations issued prior to July 19, 1984 will have to be disposed of right away). These banks might prefer to continue to utilize Section 882(e) for its originally intended purpose (to avoid the regular 30% withholding tax) until the older investments can be disposed of without adverse effect, even if this might mean that they would continue to be exposed to the regular corporate income tax on the taxable income which might result. However, in foregoing the election out of

Section 882(e), they should still be afforded relief from the harsh effects of the Tax Reform Act of 1986 cited herein. Accordingly, the following additional amendments are proposed.

- For possession banks which may choose not to avail themselves of the "election out" of Section 882(e), amend Section 884, the branch tax rule, to provide that the taxes provided for in that Section shall be determined without regard to any income which is treated as U.S. effectively connected income solely by reason of Section 882(e), and the assets and liabilities related thereto.
- Also for possession banks which may choose not to avail themselves of the "election out" of Section 882(e), amend Section 861(a)(2)(B), the dividend sourcing rule, to provide that the determination of U.S. effectively connected income for purposes thereof shall be made without regard to any income which is treated as U.S. effectively connected income solely by reason of Section 882(e).

ILLUSTRATION OF ADVERSE EFFECTS OF SECTION 882(e) ON PUERTO RICAN BANKS

	Puerto Rican banks	Other foreign investors
ASSUMED FACTS:		
Interest income from U.S. government obligations	$10,000,000	$10,000,000
Deductions allowed against effectively connected income:		
Interest expense allocated	(9,000,000)	N/A
Other expenses allocated	(500,000)	N/A
Taxable income	$ 500,000	N/A
TAX UNDER OLD LAW:		
"Regular" federal tax (34% of $500,000)	$ 170,000	None
ADDITIONAL TAXES UNDER NEW LAW:		
Branch level tax on interest deduction (30% of $9,000,000)	$ 2,700,000	None
Potential additional branch level tax on dividend equivalent amount (30% of $500,000 less $170,000)	$ 99,000	None

Bank of America

Peter H. Levy
Senior Tax Counsel

Tax Department

July 23, 1987

U.S. Senate Finance Committee
S.D. 205
Washington D.C. 20310

Subject: Technical Corrections Act of 1987

Gentlemen:

On behalf of BankAmerica Corporation and on behalf of the corporations included with BankAmerica Corporation in its consolidated Income Tax Return including Bank of America National Trust & Savings Association, the following comments are respectfully submitted.

1) Act Section 112(a)(3) modifies the "look-thru" (sic) provision of 904(d)(3) in a manner which discriminates against recipients of financial services income. This paragraph, for example, permits high withholding tax interest received by a manufacturing company from its wholly-owned manufacturing subsidiary to be treated as overall limitation income. On the other hand, if a Bank makes an intercompany loan to an Indonesian subsidiary engaged in the banking business strictly within Indonesia, the tax withheld on repayments by the subsidiary will not be subject to the "look-thru" rule, and thus will be treated as high withholding tax interest.

The taxpayer believes that this provision is inappropriate and unconscionable for the following reasons:

(a) It discriminates against a particular industry for no apparent reason;

(b) It is not a technical correction in that it substantially alters the operation of this Code Section without furthering any intention expressed in the prior Committee Reports; and

(c) It is inconsistent with the conference agreement. Volume II, page 586 of the conference report accompanying HR 3838 states: "The conference agreement does not limit the application of the separate limitation for high withholding tax interest to interest earned by banks, financial institutions, insurance companies, and related persons. The agreement extends the provision's application to all interest recipients (...) because entities other than financial institutions making high withholding tax loans may receive the same tax advantages under present law as financial institutions making such loans..."

"Consistent with its extension of the provision to all interest recipients..."

That same portion of the conference report goes on to indicate that the look-through rules themselves operate to prevent the potential abuse which might result were the Indonesian subsidiary itself to make a high withholding tax loan to an unrelated customer.

Additionally, the Bank wishes the committee to note that the only reliable source of non-local currency funding for subsidiaries of American banks in many foreign jurisdictions is an intercompany loan. Thus, imposition of this harsh provision with respect to intercompany loans may substantially undercut the competitive position of American banks doing business abroad.

2) Act Section 112(a)(5) amends the grandfather rules for tax credits with respect to high withholding tax interest by specifying that "all members of an affiliated group of corporations filing a consolidated return shall be treated as one corporation". The taxpayer is concerned that this creates or leaves in place ambiguity with respect to loans generating high withholding tax interest in the hands of foreign affiliates. We suggest that the rule be clarified to eliminate any potential differentiation between domestic and foreign affiliates for purposes of the grandfather rules by adding the following phrase after the word "return" in the preceding sentence: "and any controlled foreign corporation (within the meaning of § 957) in which one or more includible corporations (within the meaning of § 1504(b)) is a U.S. shareholder (within the meaning of § 958)".

We believe that this modification is consistent with the intent to grandfather existing loans to borrowers resident in the enumerated countries. Any movement of a loan participation from a domestic to a foreign corporation or vice versa should not affect capacity under the grandfather rule.

Respectfully submitted,

PHL11:11:tmi

Bank of America

Peter H. Levy
Senior Tax Counsel

Tax Department

July 23, 1987

U.S. Senate Finance Committee
S.D. 205
Washington D.C. 20310

Subject: Technical Corrections Act of 1987
BankAmerica Corporation Summary of Comments

Gentlemen:

1) Act Section 112(a)(3) modifies the "look-thru" (sic) provision of 904(d)(3) in a manner which discriminates against recipients of financial services income.

The taxpayer believes that this provision is inappropriate and unconscionable for the following reasons:

(a) It discriminates against a particular industry for no apparent reason;

(b) It is not a technical correction in that it substantially alters the operation of this Code Section without furthering any intention expressed in the prior Committee Reports; and

(c) It is inconsistent with the conference agreement.

2) Act Section 112(a)(5) amends the grandfather rules for tax credits with respect to high withholding tax interest by specifying that "all members of an affiliated group of corporations filing a consolidated return shall be treated as one corporation". The taxpayer is concerned that this creates or leaves in place ambiguity with respect to loans generating high withholding tax interest in the hands of foreign affiliates.

Respectfully submitted,

PHL11:12:tmi

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July 20, 1987

By Hand

William Wilkins, Esq.
Chief Tax Counsel
Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20515

Re: Comments on Technical Corrections Act of 1987 -- Amendment to Alternative Minimum Tax Concerning Bank Bad Debt Reserves

Dear Bill:

I am enclosing a statement regarding the proposed Technical Corrections Act of 1987 on behalf of the following bank companies:

Bank of America
Bankers Trust Company
Chemical Bank
Citibank
Continental Illinois National Bank and Trust Company of Chicago
First National Bank of Chicago
Irving Trust Company
Manufacturers Hanover Trust Company
Mellon Bank

We are proposing a technical correction to section 701 of the Tax Reform Act of 1986, which concerns the alternative minimum tax for corporations. The alternative minimum tax provision in the 1986 Act fails to take account of a timing difference between book and tax income caused by repeal of the tax bad debt reserve. Because the reserve continues to be maintained for book purposes, taxable income is accelerated under the alternative minimum tax, creating a very large potential double tax when the bad debt is subsequently deducted for tax purposes. This is the reverse of the timing difference addressed by the alternative minimum tax credit, and it therefore requires a new and different solution.

This problem is a very serious one for commercial banks. The extraordinary additions to bad debt reserves that have been made this year with respect to loans to the less developed countries have greatly magnified the adverse impact of this technical problem with the minimum tax. Consequently, unless the provision is amended, commercial banks will be subject to a very substantial and unintended double tax on the same income.

We appreciate the opportunity to comment on the proposed legislation.

Sincerely,

John E. Chapoton

JEC/kmw
Enclosure
cc w/enclosure: Laura Wilcox (5)
Mary McAuliffe (5)
John Colvin

CORPORATE ALTERNATIVE MINIMUM TAX

Book Income Adjustment

Technical Correction to Provide Limited Adjustment for Bad Debt Reserves of Commercial Banks

[Tax Reform Act §§701, 702 & 901; Code §§56(f) & 53]

Background

The Tax Reform Act of 1986 ("Act") repealed the prior add-on minimum tax on corporations and created a new alternative minimum tax ("AMT") at a rate of 20 percent. The tax base for the corporate AMT consists generally of regular taxable income increased by the taxpayer's tax preferences and adjustments to negate accelerated deductions, and reduced by the exemption amount. A new item included in the AMT base as a preference for corporations for tax years beginning in 1987, 1988, and 1989 is the adjustment for book income. In general, a corporate taxpayer is required to increase its alternative minimum taxable income ("AMTI") by one-half of the difference between the adjusted net income it reports for financial statement purposes and its AMTI before this adjustment. After 1989, the book income adjustment is to be replaced by a new, broader measure of business profits more precisely defined and tied to tax earnings and profits -- "adjusted current earnings."

As under prior law, the Act provides a credit in the amount of the minimum tax paid that may be used to offset regular tax liability (but not below minimum tax liability) in future taxable years. Only the minimum tax attributable to timing differences between book and tax income ("deferral preferences" as opposed to "exclusion preferences") can be carried forward in this manner. This type of timing difference arises when a tax deduction occurs in advance of the book deduction, such as in the case of accelerated depreciation for tax purposes. The effect of such tax preferences is to defer taxable income (and thus regular tax liability) to a future year. The AMT credit corrects for this timing difference and prevents double taxation by allowing a minimum tax paid to offset regular tax liability in future years. The Act treats the book income adjustment as a deferral preference for this purpose.

The Act also repealed the deduction for bad debt reserves for most taxpayers and in so doing created a new type of timing difference. Taxpayers must now generally account for bad debt losses using the specific charge-off method for tax purposes -- i.e. taking a deduction when a debt is actually written off -- even if they maintain bad debt reserves for financial accounting purposes. Thus, the repeal of the tax bad debt reserve has the opposite effect of a deferral preference. A deferral preference defers taxable income, and hence regular taxes, to future years. Use of a reserve for book but not tax purposes postpones book income and consequently accelerates taxable income and regular tax. This "reverse" timing difference has been incorporated into the minimum tax through the book income adjustment, with the result that a taxpayer may be subject to minimum tax liability with respect to income that has already been subject to tax, in the subsequent taxable year in which the bad debt deduction is allowed for tax purposes.

The amount of double tax liability that will result from this reverse timing difference will be very substantial in the case of banks that have made extraordinary additions to bad debt reserves in 1987 to account for expected losses on loans made in the less developed countries. Such additions will reduce 1987 book income below the level of AMTI. To the extent this occurs, under present law banks will, in effect, lose their loan loss deduction from book income because no effect is given to a negative book income adjustment. Consequently, unless a mechanism is provided to carry such a negative adjustment forward, a double tax will occur in 1988 and 1989 when a corresponding loan loss deduction occurs for tax purposes, which will always increase the book income adjustment by the full amount of the deduction. In other words, tax and book deductions are not fully offsetting, as it was contemplated they would be.

Proposed Technical Correction

It is proposed that there be an adjustment to AMTI solely for purposes of determining the book income adjustment in 1988 and 1989. Any tax deduction taken by a taxpayer that represents the charge-off of a loan against an addition to the taxpayer's loan loss reserve in a prior post-1986 taxable year would be added to AMTI (the "loan loss addback"). This adjustment could not exceed the "negative book income preference" -- i.e. the amount by which adjusted net book income was less than AMTI in 1987.

An additional adjustment may be necessary if any additions to bad debt reserves are reversed by a bank in a subsequent year. Adjusted net book income for the 1988 and 1989 taxable years should be decreased to reflect any recapture of amounts that were added to the taxpayer's bad debt reserve in prior post-1987 taxable years. The amount of this decrease should also be limited to the negative book income adjustment.

Reasons for Amendment

The purpose of the corporate AMT adopted in the 1986 Act is to ensure payment of at least a 20 percent tax on economic income. A perception of unfairness in the tax system arises, it is believed, when some taxpayers with economic income pay little or no tax, even though the reduced tax liability is a result of incentives and preferences built into the tax system and despite the fact that the benefits of tax preferences are very often passed through by the taxpayers who are their direct beneficiaries.

The book income adjustment to taxable income created by the 1986 Act is not a preference item in the general sense. It is addressed to no particular tax preference item, but only to general differences in income reporting, which may arise for many reasons. No explanation of the purpose of the book income adjustment is provided in the legislative history of the 1986 Act. The Joint Committee staff's General Explanation indicates only that its purpose was to "achieve both real and apparent fairness" by requiring that some tax be paid whenever a taxpayer publicly reports earnings on its financial statements. General Explanation at 434.

The purpose of the minimum tax credit is to ensure that, if a deferral preference creates a timing difference, the same amount of income will not be taxed twice -- once when a deduction is taken for regular tax purposes and again after the timing difference reverses. However, in the case of the reverse timing difference created by the repeal of the bad debt reserve, the minimum tax credit provides no relief. The absence of relief is particularly unfair because this timing difference is not a preference. There is no deferral of the tax liability (as ordinarily results from a timing preference); instead there is an acceleration of tax liability. Under the minimum tax as presently in effect, taxpayers with identical income may incur different tax liabilities, as the examples set out in the Appendix demonstrate. Such a result is inherently unfair and should certainly be remedied.

The proposed loan loss addback adjustment is intended to avoid the double taxation that otherwise would result from this reverse timing difference. Under the proposed provision, taxpayers with similar economic incomes for the period during which the book income adjustment is in effect will pay similar amounts of tax. The provision should create no perception of unfairness. Indeed, it is essential to prevent <u>real</u> unfairness. As the attached example illustrates, a taxpayer that has no economic income could have a minimum tax liability absent the type of adjustment being proposed. Clearly it is fair to prevent the assessment of a double tax and provide equitable tax treatment for similarly situated taxpayers.

The double tax that can result from the timing difference created by the repeal of the tax bad debt reserve is obviously an unintended glitch. The drafters of the minimum tax provision explicitly assumed that, absent tax preferences, AMTI would not be less than book income. Senate Report at 520 n. 4. In fact, that is exactly what happens to a commercial bank that maintains a book bad debt reserve when it writes off a loan for tax purposes. The bad debt deduction in the later year corresponds to a book deduction claimed in an earlier year (which is not a tax preference but a tax penalty). Moreover, the double taxation problem created by the repeal of the bad debt reserve is limited to the 1987 through 1989 taxable years. The adjusted current earnings mechanism that becomes effective in 1990 will eliminate the loan loss reserve problem because it is limited to recapturing true tax preferences and thus does not affect bad debt deductions. And the adjusted current earnings concept was intended to be at least as broad as the book income adjustment in its coverage. General Explanation at 435.

In addition, if no technical correction is made, commercial banks might be discouraged from making needed adjustments to loan loss reserves because of the double tax liability that might result. This result conflicts with the expressed intent of Congress that the minimum tax provision not interfere with appropriate methods of accounting. General Explanation at 456.

Supplemental Information

This statement is submitted by John E. Chapoton, Thomas A. Stout, Jr., Christine L. Vaughn and Debra J. Duncan of Vinson & Elkins, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of the following:

Bank of America
Bankers Trust Company
Chemical Bank
Citibank
Continental Illinois National Bank and Trust Company of Chicago
First National Bank of Chicago
Irving Trust Company
Manufacturers Hanover Trust Company
Mellon Bank

APPENDIX

The following example illustrates the inequity that occurs when two banks, which over time have the same book income and charge-offs, use different financial accounting methods. The example demonstrates that the present AMT does not contemplate the existence of the reverse timing difference created by loan loss reserves. The result is that one bank pays tax while the other pays no tax even though neither bank has any economic income. Contrary to Congressional intent that the book income adjustment not interfere with financial accounting methods, total tax paid depends on whether the taxpayer uses a reserve method of accounting for book purposes.

Assumptions:

- Bank A and Bank B have no alternative minimum tax preferences or adjustments other than the book income adjustment. Thus, taxable income and alternative minimum taxable income before the book income adjustments are equal.

- Bank A has a loan loss provision for book purposes in 1987, and takes bad debt deductions for tax purposes equal to that provision over 1988 and 1989. Bank B has a book loan loss provision for each year equal to its tax charge-off for that year.

- Neither Bank A nor Bank B have a portfolio of pre-8/7/86 tax-exempt obligations, or any other tax-exempt obligation which would be subject to the minimum tax through the book/tax adjustment.

- Neither Bank A nor Bank B have foreign tax credits in any year.

BANK A

1987:

FINANCIAL STATEMENT			TAX RETURN		
Book Income Before Loan Loss	=	$ 1,000	Taxable Income	=	$ 1,000
Loan Loss Provision	=	3,500	Charge-Off	=	0
Pre-Tax Book Income (Loss)	=	$ (2,500)	Net Taxable Income	=	$ 1,000

Summary:

	Book	Tax Return
Income	$ (2,500)	$ 1,000
Loan Loss/Charge-Off	3,500	0
Minimum Tax Liability	0	N/A
Regular Tax Liability	N/A	400

1988:

Book Income Before Loan Loss	=	$ 1,000	Taxable Income	=	$ 1,000
Loan Loss Provision	=	0	Charge-Off	=	1,000
Pre-Tax Book Income	=	$ 1,000	Net Taxable Income	=	$ 0

Summary:

	Book	Tax Return
Income	$ 1,000	$ 0
Loan Loss/Charge-Off	0	1,000
Minimum Tax Liability	100	N/A
Regular Tax Liability	N/A	0

1989:

Book Income Before Loan Loss	=	$ 1,500	Taxable Income	=	$ 1,500
Loan Loss Provision	=	0	Charge-Off	=	2,500
Pre-Tax Book Income	=	$ 1,500	Net Taxable Income	=	$ (1,000)

Summary:

	Book	Tax Return
Income	$ 1,500	$ (1,000)
Loan Loss/Charge-Off	0	2,500
Minimum Tax Liability	50	N/A
Regular Tax Liability	N/A	0
Regular Tax Refund	N/A	400

Cumulative Summary:

	Book	Tax Return
Income	$ 0	$ 0
Loan Loss/Charge-Off	3,500	3,500
Minimum Tax Liability	150	N/A
Regular Tax Liability	N/A	400
Regular Tax Refund	N/A	400

BANK B

1987:

FINANCIAL STATEMENT			TAX RETURN		
Book Income Before Loan Loss	=	$ 1,000	Taxable Income	=	$ 1,000
Loan Loss Provision	=	1,000	Charge-Off	=	1,000
Pre-Tax Book Income (Loss)	=	$ 0	Net Taxable Income	=	$ 0

Summary:

	Book	Tax Return
Income	$ 0	$ 0
Loan Loss/Charge-Off	1,000	1,000
Minimum Tax Liability	0	N/A
Regular Tax Liability	N/A	0

1988:

Book Income Before Loan Loss	=	$ 1,000	Taxable Income	=	$ 1,000
Loan Loss Provision	=	1,000	Charge-Off	=	1,000
Pre-Tax Book Income	=	$ 0	Net Taxable Income	=	$ 0

Summary:

	Book	Tax Return
Income	$ 0	$ 0
Loan Loss/Charge-Off	1,000	1,000
Minimum Tax Liability	0	N/A
Regular Tax Liability	N/A	0

1989:

Book Income Before Loan Loss	=	$ 1,500	Taxable Income	=	$ 1,500
Loan Loss Provision	=	1,500	Charge-Off	=	1,500
Pre-Tax Book Income	=	$ 0	Net Taxable Income	=	$ 0

Summary:

	Book	Tax Return
Income	$ 0	$ 0
Loan Loss/Charge-Off	1,500	1,500
Minimum Tax Liability	0	N/A
Regular Tax Liability	N/A	0

Cumulative Summary:

	Book	Tax Return
Income	$ 0	$ — 0
Loan Loss/Charge-Off	3,500	3,500
Minimum Tax Liability	0	N/A
Regular Tax Liability	N/A	0

Note: This example also illustrates what the result would be if adjusted earnings and profits were the measure for the minimum tax adjustment, rather than the book/tax adjustment.

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June 30, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room S D - 205
United States Senate
Washington, D.C. 20510

Re: Comments on Technical Corrections Legislation

Dear Ms. Wilcox:

This letter is a response to Chairman Lloyd Bensten's request for comments to the Technical Corrections Bill of 1987. My comments are isolated to the Generation-Skipping Transfers Act provisions. More specifically, my comment relates to Section 114 (g)(3) of the Technical Corrections Bill (hereinafter referred to as the "Bill") and Section 1433 of The Tax Reform Act of 1986 (hereinafter referred to as the "Act").

Since the Act was signed into law, many taxpayers, relying on the Committee Reports, "Blue Book" and tax professionals have made gifts in trust for their grandchildren to take advantage of the $2,000,000 per grandchild exemption provided under Section 1433 (b)(3) of the Act. The House Committee report to the Act states as follows:

> "A special exemption from the Generation-Skipping Transfer Tax is provided for certain direct skips (either in Trust or otherwise) to grandchildren of the grantor. For each guarantor, this special exemption is limited to $2,000,000. per grandchild."

The "Blue Book" prepared by the Staff of the Joint Committee on Taxation released on May 7, 1987 states on page 1266:

> "A special exemption from the generation-skipping transfer tax is provided for certain direct skips (either in trust or otherwise) to grandchildren of the grantor prior to 1990. For each grantor, this special exemption is limited to $2 million per grandchild."

Although there were certain technical deficiencies in the drafting of this $2,000,000. per grandchild exemption, many tax professionals were, prior to release of the Bill, under the impression that a gift to a Trust established for a grandchild would qualify for the $2,000,000. per grandchild exemption if the Trust was an Estate Trust from which distributions of income or principal may be made to a single grandchild during the term of the Trust, and which is payable to the grandchild's estate upon the grandchild's death prior to the time otherwise specified for trust termination. See PLANNING OPPORTUNITIES THAT TAKE ADVANTAGE OF THE NEW GENERATION-SKIPPING TAX PROVISIONS, 14 Estate Planning Magazine 66 (March/April, 1987).

There were no provisions in the Act, nor the Committee Reports that would give a tax professional any idea at all that to qualify for the $2,000,000 exemption, all of the income of the Trust must be distributed to the grandchild no less often than annually once the grandchild reaches age twenty-one. This requirement was added by Section 114 (g) (3) (B) (iii) of the Bill.

Because of the substantial tax benefit of taking advantage of the $2,000,000 per grandchild tax exemption, many tax professionals and taxpayers relied on the language of the Act, and the House Committee Report (which appeared to have been followed by the Conference Committee Report), and the "Blue Book", and made gifts into estate trusts with provisions similar to those described above. Obviously, to obtain the desired estate tax advantage, these trusts must be irrevocable.

It appears that the Bill goes beyond the scope of the Act with respect to the requirement that all income of a trust be distributed once a grandchild attains the age of twenty-one, especially if the Trust is an estate trust which must be included in the grandchild's estate if he predeceases the date that trust assets would otherwise be distributed outright to the grandchild.

Those taxpayers who established estate type trusts as described above should not be penalized by the substantive change made by the Bill to the $2,000,000 per grandchild exemption. Either the Bill should be amended to provide that an estate type trust qualifies for the $2,000,000 exemption under the circumstances described above regardless of whether income is distributed annually, or such trusts established before taxpayers reasonably became aware of this new requirement should be "grandfathered in". This position would be consistent with the provisions of Section 2056 (b) which effectively provides that an estate trust is not to be considered to be a terminable interest.

A distribution to a grandchild through an estate trust is preferred by many persons who do not want their grandchildren to obtain large sums of income upon attaining the age of twenty-one years. These same grandparents prefer not to make outright distributions to their grandchildren, not for tax purposes, but to prevent a situation where the grandchild is not financially mature enough to manage such funds for the grandchild's best interest. There should be no tax policy that requires a grandparent to make either an outright gift to a grandchild or a gift in a trust that requires income to be distributed to the grandchild upon attaining age twenty-one where the accumulated income of the Trust will, in any case, be included in the grandchild's estate in the event that the grandchild predeceases the date he otherwise would receive outright distributions from his trust. Futhermore any accumulated income will be subject to income tax at the new, less preferential, trust income tax rates.

Based upon the discussion above, I believe it would be more appropriate to change the Bill in order to permit an estate trust to qualify for the $2,000,000 grandchild exemption. I can think of no rationale that would require a grandparent to make a distribution to a grandchild whereby the grandchild would be receiving substantial sums of income upon attaining their twenty-first birthday in order to qualify for favorable tax treatment. Even at a five percent rate of return, grandchildren would be receiving income of as much as $100,000 per year from qualified exemption trusts upon attaining age twenty-one if the full $2,000,000 exemption amount is deposited in such a trust. Furthermore, if the terms of the Trust permit accumulation of income until the child attains the age of twenty-one years, then it is likely that the amount of income available for distribution when the grandchild attains age twenty-one would be substantially greater than $100,000 per year. Very few of my clients desire that their grandchildren obtain any where near these sums when their grandchildren are in the years of their lives where they should be attending college and graduate school.

For the reasons mentioned above, I strongly suggest that the terms of the $2,000,000 exemption provision be amended to allow an estate trust (and possibly a General Power of Appointment Trust) to qualify for the $2,000,000 per grandchild exemption without the requirement that income be distributed annually once a grandchild attains age twenty-one.

Very truly yours,

Barry A. Nelson

BARRY A. NELSON

TECHNICAL CORRECTIONS BILL MAKES SUBSTANTIVE CHANGES TO $2 MILLION PER GRANDCHILD GENERATION-SKIPPING EXEMPTION

By: **Barry A. Nelson, Esquire**
Barry A. Nelson, P.A.
Miami, Florida

General

The Tax Reform Act of 1986 (TRA'86) provides an exemption from generation-skipping transfer tax for transfers before January 1, 1990 from a donor to a grandchild of the donor of up to $2 million per grandchild.[1] Since enactment of TRA'86, tax professionals have been considering the best method for their clients to make such gifts to their grandchildren which qualify for the $2 million per grandchild exemption.

The planning considerations for utilizing the $2 million per grandchild exemption are similar to the considerations for the $10,000 annual exclusion. Taxpayers must take advantage of these exclusions/exemptions while they are alive because only once such gifts are made can a taxpayer be certain that his untimely death will not result in the loss of such exclusions/exemptions. Furthermore, the earlier such exclusions/exemptions are utilized, the greater amount of appreciation and income from the transferred assets avoids estate and generation-skipping taxes in the donor's estate.

Gifts in Trust

Unfortunately, since the enactment of TRA '86, many tax professionals have been uncertain as to whether gifts made in trust for grandchildren subsequent to enactment qualify for the $2 million per grandchild exemption. Many tax commentators have expressed their concern about certain technical pitfalls in the generation-skipping provisions of TRA '86.[2] As a result of these technical pitfalls certain professionals have advised against making gifts in trust for grandchildren.[3] Others have advised making gifts to "an estate trust from which distributions of income or principal may be made to a single grandchild during the term of the trust, and which is payable to the grandchild's estate upon the grandchild's death prior to the time otherwise specified for trust termination".[4]

Technical Corrections Bill Changes

The Technical Corrections Bill of 1987 (the "Bill") provides guidelines for trusts that will qualify for the $2 million per grandchild exemption. Section 114(g)(3)(B) of the Bill provides that a transfer in trust for the benefit of a grandchild shall be treated as a transfer to such grandchild if (and only if):

> "(i) during the life of the grandchild, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such grandchild,
>
> "(ii) the assets of the trust will be includible in the gross estate of the grandchild if the grandchild dies before the trust is terminated, and
>
> "(iii) all of the income of the trust for periods after the grandchild has attained age 21 will be distributed to such grandchild not less frequently than annually."

Non-Tax Pitfalls Resulting from the Bill

Unfortunately, the requirement of annual income distributions provided in Section 114 (g)(3)(B)(iii) of the Bill is likely to conflict with the non-tax objectives of many potential donors. For example if a wealthy individual wants to take full advantage of the $2 million per grandchild exemption by making a gift in trust, then under the Bill the donor could establish a $2 million discretionary trust for his grandchild provided that income from the trust be distributed at least annually when the grandchild (i.e., Samantha) attains age 21. The trust must also satisfy the other requirements of Section 114 (g)(3). Assuming (i) Samantha is 18 years of age when the gift is made; (ii) income accumulates until Samantha attains her 21st birthday; and (iii) a 5% after tax rate of return (without compounding); the assets in Samantha's trust will grow to $2.3 million by her 21st birthday. To satisfy the new requirements under the Bill, Samantha must have the right to receive all of the annual trust income (assumed to be $115,000) outright upon reaching her 21st birthday.

Very few clients believe it is appropriate to create a trust that requires substantial distributions to a 21 year old because giving such large sums is likely to create serious disincentives for the 21 year old. For example, just consider what is likely to happen when a 21 year old college student receives a $115,000 check at his fraternity house from a generation-skipping trust established by the student's grandparent. Possibly such a distribution could result in the plot for a new movie - "Animal House II - Toga Party After Receipt of Income From Generation-Skipping Trust." Most 21 year olds are in their third year of college at age 21 and would find it difficult handling the receipt of such a large amount of money on an annual basis.

Current Options

The Bill (in its current form) creates a difficult decision for taxpayers desiring to make gifts to their grandchildren who may not be mature enough to handle receipt of the amount of income that would be required to be distributed annually when such grandchildren attain age 21. Of course, arguably trust investments can be made to minimize trust income. However, possibly the beneficiary may be required to have the right to make trust assets productive as is the case with marital deduction trusts.

The policy benefits requiring that income be distributed annually for a trust to qualify for the $2 million exclusion appear to be substantially outweighed by the pitfalls described above. It does not appear that there would be substantial additional taxes generated by the requirement that income be distributed annually assuming any accumulated income will be taxed to the trust at the new, less preferential, trust income tax rates and since all trust assets must be includible in the grandchild's gross estate to qualify for the $2 million per grandchild exemption, if the grandchild dies before the trust is terminated. Since there does not appear to be a tax generating benefit, it certainly would appear that the policy considerations weigh against the requirement that income be distributed annually. Our tax policy should not require the distribution of large sums when our children and grandchildren attain age 21 in order to qualify for tax benefits.

Congress decided that the $2 million per grandchild exemption should be available for a transitional period. The law should be drafted so that taxpayers can make gifts in trust where income can be accumulated until a beneficiary reaches an age that more typically would be a time when financial maturity is attained. For most of my clients the earliest time for large mandatory distributions is typically no earlier than age 25, notwithstanding the fact that income accumulations beyond age 21 may be subject to the throwback provisions.

Conclusion

Our wealthy clients are now faced with a dilemma. If our clients delay making gifts until the Bill is amended or is enacted "as is", they risk the possibility of dying and losing the substantial tax benefits of making gifts to their grandchildren taking advantage of the $2 million per grandchild exemption. However, if our clients are not comfortable with making large gifts outright or into a trust that requires mandatory income distributions then they are basically forced into inaction. Possibly an irrevocable trust can be established whereby the terms of the trust provide that the requirement that income be distributed annually will be deleted if the Bill is amended and income distributions are no longer required.

Another problem with the Bill relates to taxpayers who may have established trusts for purposes of qualifying for the $2 million exemption under the Act prior to the release of the Bill. It appears that there are no grandfathering provisions for such irrevocable trusts that may have been established subsequent to enactment of TRA '86 and before taxpayers reasonably received notice of the additional substantive requirements under the Bill. Consideration should be given to amending the Bill to delete the requirement that income be distributed annually or at least to provide for the grandfathering of irrevocable trusts established since enactment of TRA '86.

1. TRA '86, Section 1433(b)(3).

2. See Mulligan and Boulton, "Planning Opportunities That Take Advantage of the New Generation-Skipping Tax Provisions", 14 Estate Planning 66 (March/April 1987) and Schneider "Generation-Skipping Transfer Taxes Under Tax Reform 1986" 21 University of Miami Estate Planning Institute (1987).

3. Schneider "Generation-Skipping Transfer Taxes Under Tax Reform 1986" 21 University of Miami Estate Planning Institute (1987).

4. Mulligan and Boulton, "Planning Opportunities That Take Advantage of the New Generation-Skipping Tax Provisions", 14 Estate Planning (March/April 1987).

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Billy Graham EVANGELISTIC ASSOCIATION

1300 HARMON PLACE MINNEAPOLIS, MINNESOTA 55403, U.S.A (612) 338-0500

June 30, 1987

Laura Wilcox
U.S. Senate Committee on Finance
SD 205
Washington DC 20510

Dear Ms. Wilcox:

It is my understanding that the Senate Finance Committee will be considering the Technical Corrections Act of 1987 (H.R. 2636) in the next few weeks. I would urge the Finance Committee to support an amendment to the act to clarify that Charitable Gift Annuities, issued by IRC Section 501(c)(3) organizations are not "commercial-type insurance" under IRC Section 501(m).

Because the Tax Reform Act of 1986, that adopted this new section 501(m), does not directly address this exemption it has been feared by many of us in the non-profit community that someone might erroneously interpret this legislation to apply to Charitable Gift Annuities.

Charitable Gift Annuities are used because donors to qualified IRC Section 501(c)(3) organizations want to make gifts to the organization of their choice but don't feel they can totally release the income they receive on their money. The primary motivation of these gifts is the charitable support desires of the donor and not the ability to make a market competitive rate of income. In fact, for the same amount of money an individual could receive an income of approximately double what they would receive from a Charitable Gift Annuity. Obviously Charitable Gift Annuities issued by non-profit organizations are not in competition with commercial insurance company annuities.

The Charitable Gift Annuity has been used by charitable organizations for over 100 years. It is primarily used by donors having a limited source of assets. It compares in many respects to the Charitable Remainder Annuity Trust regulated under IRC Section 564. One major difference is in the amount of funds needed. Most Charitable Remainder Annuity Trusts would require a minimum of $40,000 or $50,000, in fact, some organizations have a minimum of $100,000. However, Billy Graham Evangelistic Association requires a minimum of only $500 for a Charitable Gift Annuity and our average annuity is between $1,000 and $2,000. As you can see this provides an opportunity for people with limited assets to be able to make that charitable gift they desire to make but still retain the ability to receive an income for their life. The issue that concerns us greatly is that the Charitable Remainder Annuity Trust is unaffected by IRC Section 501(m) but we don't know for sure what the status is for Charitable Gift Annuities.

Failure to clarify the Tax Reform Act of 1986 in this regard would result in the drying up of a significant source of funds for our organization's charitable activities.

I would greatly appreciate the Senate Finance Committee's leadership in amending the Technical Corrections Act of 1987 to make it clear that IRC Section 501(m) does not apply to Charitable Gift Annuities.

Sincerely,

Jack Richardson

Jack Richardson, CPA
Director of Development

JR:ad

BIOLA UNIVERSITY

July 23, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Sir:

RE: IRC Sec. 501(m)
Technical Corrections Act, 1987 (H.R. 2636)

Experience has taught that an ambiguous statement in the law leads to confusion, numerous interpretations, uncertainties and law suits. I request that loss of time and costs be avoided by clearly stating in the Technical Corrections Act of 1987 (H.R. 2636) that charitable gift annuities are not subject to IRC Sec. 501(m).

It has been the policy of the U.S. Government to encourage charitable giving and charitable organizations have used gift annuities for over 100 years as one source of charitable giving. Charities are permitted to immediately use a portion of the annuity purchase funds for their charitable purposes.

Charitable gift annuities do not compete with commercial annuities and are not "commercial-type insurance." H.R. 2636 can be amended to clarify any doubts in the minds of those who do not understand charitable gift annuities.

Many small donors use the charitable gift annuity as an avenue to assist the charity of their choice. Please do not deny these donors this privilege. Amend H.R. 2636 by clearly stating that charitable gift annuities are not subject to IRC Sec. 501(m).

Sincerely,

Gary R. Boren

Gary R. Boren, Director
Planned Giving Services

SAS:GRB:fad

Parris Afton Bonds
Phone 505-392-4139
1105 West Alabama
Hobbs, New Mexico 88240

September 1, 1987

SENATE FINANCE COMMITTEE
Laura Wilcox, Hearing Clerk
SDOB 205
Washington, D. C. 20510

Dear Ms. Wilcox:

Because of the nature of the writing business, the 1986 Tax Reform Act will be devastating to the freelance writer. As taxpayer and a freelance writer, I request that a clarification be made in the Technical Corrections Bill S1350, stating that freelance authors' expenses in researching and writing a book not be suject to capitalization rules! I would like this to be made part of the official comments on the bill.

Sincerely,

Parris Afton Bonds

Parris Afton Bonds

Boulder Community Hospital Foundation

July 15, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

RE: CHARITABLE GIFT ANNUITIES

Dear Ms. Wilcox:

I am writing to request your support for an amendment to the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec.501(c)(3) organizations, such as our Boulder Community Hospital Foundation, are not "commercial-type insurance" under IRC Sec.501(m).

Currently, IRC Sec.501(m) -- enacted by TRA '86 -- could be misinterpreted and treat charitable gift annuities as "commercial-type insurance." If so, charities would be taxed as insurance companies on their gift annuity programs or, in extreme cases, lose their tax exemption altogether. While we do not issue many charitable gift annuity contracts, we certainly would like to be able to offer this planned giving opportunity to our donors and not jeopardize our Foundation's tax exempt status.

Gift annuities are used because an interested donor wants to make a gift to help our hospital. Gift annuities don't compete with commercial annuities and are not "commercial-type insurance." Failure to clarify the law would dry up an important source of funds for the hospital. For the small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec 501(m).

For these reasons, your assistance in clarifying Congress's intention pertaining to charitable gift annuities will be most appreciated.

Sincerely,

Max C. Coppom
President

MCC:af

July 14, 1987

Comments on 1987 Technical Corrections Act:

In our efforts and haste to reduce government spending and lower the deficit, we sometimes do some things that we think will help raise revenue but in fact will hurt people who should not be hurt. We are writing you concerning two items that may be included in the 1987 Technical Corrections Act that should be changed or eliminated.

1) Charitable Gift Annuities - IRC Sec 501 (m). The proposal to treat all Annuities "as providing insurance" will not only be very unfair but will prevent a great number of widows from obtaining a source of income that they desperately need. Maybe you do not know that we, through gift annuities, provide a much needed source of income for widows whose only asset is the house they live in. Through the gift annuity, they can give us their house and we can pay them an income for the rest of their lives to supplement their meager social security income and allow them to live their remaining life in dignity.

These gift annuities are only in one form, they have no variable features, no refunds and no death benefit. It is very hard for us to see how this annuity should "be treated as providing insurance."

We feel that there is only one action you need to take and that is in 501 (m)(4), after the word "annuities", insert "other than charitable gift annuities."

2) Charitable lead trust, IRS Sec. 2642 (a)(2)(B)(ii)(II). The proposal to do away with this section which will eliminate the charitable deduction will significantly reduce the income charities could receive from charitable lead trusts. What you may not know is that the decline in the oil industry and agriculture has placed a lot of charities and non-profit organizations, such as ours, in financial stress. Now you are proposing to eliminate this valuable source of lead trust gifts.

We sincerely solicit your help in these two matters and trust that charitable giving can continue through these sources.

Submitted by: Dr. Eugene E. Hughes
Director of Estates and Financial Planning

Summary

1) Charitable Gift Annuities are not and never have been like commercial insurance company annuities and should not be treated like them. These gift annuities are a significant

source of income for widows who have only a meager social security to live on. For their sakes, please see that the words "other than charitable gift annuities" are inserted after "annuities" in Section 501 (m)(4).

2) Charitable Lead Trusts are a significant source of income for charities and the elimination of the charitable deduction from the generation skipping transfer tax "inclusions formula" will destroy a source of income for many charities. This deduction must be preserved as it is in Section 2642 (a)(2)(B)(ii)(II).

STATEMENT OF
ALEX E. MEDOVICH, ESQ.
DIRECTOR OF TAXES, BOWATER, INCORPORATED
on S. 1350
the TECHNICAL CORRECTIONS ACT OF 1987
before the
SENATE COMMITTEE ON FINANCE

July 22, 1987

Investment Tax Credit and Basis Reduction
for Transition Property Under the 1986 Act

This statement analyzes the provisions of the Tax Reform Act of 1986 ("1986 Act") implementing the reduced investment tax credit ("ITC") and the corresponding adjustment to the basis of property with respect to which the ITC was allowed. Under several possible interpretations of new Section 49 of the Internal Revenue Code of 1986, as amended (the "Code"), it is possible that the basis of property in certain circumstances would have to be reduced by more than the amount of ITC utilized. If this were the conclusion, it could result in a portion of property otherwise subject to the allowance for depreciation which benefits from neither depreciation nor ITC.

We feel that this mismatching of depreciation and ITC was unintended. As discussed below, the legislative history to both the 1986 Act and to prior legislation supports the conclusion that an adjustment to the depreciable basis of assets is appropriate when the correct amount of ITC to be used is finally determined. Attached is an appendix to the statement with proposed technical legislation which would accomplish this result.

This problem can be illustrated by examining the treatment of ITC and the basis adjustment rules as they apply to five different types of property:

- property placed in service in 1985;
- 1985 qualified progress expenditures ("QPEs") attributable to property placed in service in 1986;
- transition property[1] placed in service in 1986;
- Transition Property placed in service in 1987; and
- Transition Property placed in service in 1988.

For purposes of this statement, we have assumed that the property referred to above is placed in service by a calendar year taxpayer who does not have sufficient tax liability to use any ITC for the taxable years 1982 through 1985.[2] With this in mind, each of these types of property will be examined in situations where the tax credit is either used in the year the property to which it relates is placed in service or carried forward and used in any of four applicable years: 1986, 1987, 1988 or 1989.[3]

I. Application of Statutory Law

As discussed below, several uncertainties exist in applying Code Section 49 to the hypothetical situations set forth above. In the paragraphs that follow in this section, we discuss conclusions that can be made by a strict interpretation of the language of Code Section 49. In the first three instances there is little doubt as to the proper conclusions. Following these cases, however, are examples where a literal reading of the Code provides ambiguous conclusions. This ambiguity is more clearly explained in Section II of this statement.

The 1985 current year business credit attributable to ITC for the property placed in service in 1985 and the 1985 QPEs attributable to property placed in service in 1986, under Code Sections 38(a)(2) and (b)(1), is 10% of the cost of the 1985 property and 10% of the amount of QPEs deemed a qualified investment in 1985 under Code Section 46(d)(1)(A). The basis of the 1985 property, for purposes of determining ACRS deductions allowed for the year and gain or loss from the sale or other disposition of the property, is clearly reduced by 5%. Sections 48(q)(1), 168(b)(1), 168(d)(1), 1001(a), 1011(a) and 1016(a)(24) of the Internal Revenue Code of 1954, as amended.

The 1986 current year business credit attributable to ITC for the Transition Property placed in service in 1986, under Code Sections 38(a)(2) and (b)(1), is 10% of the cost, but not including that portion attributable to QPEs taken in 1985, of the 1986 Transition Property. Code Sections 49(b)(1), 46(a)(1) and 46(b)(1). The basis of this property, excluding that portion attributable to QPEs, for purposes of determining the depreciation deduction allowances and gain or loss from the sale or other disposition of the property, is again clearly reduced by 10%. Code Sections 49(d)(1)(A), 48(q)(1), 168(a), 167(a), 167(g), 1011(a) and 1016(a)(22).

The final clear instance is where the ITC attributable to the 1985 property and the QPEs deemed a qualified investment in 1985 are carried forward to 1986 as permitted under Code Section 38(a)(1). In this case, the ITC clearly are allowed in full in 1986, and there is no adjustment to the earlier reduction in basis.

There is less certainty in cases where the ITC for Transition Property must be reduced below the 10% figure. There is also ambiguity as to how to reduce the basis of property attributable to pre-1986 QPEs when such property is placed in service after December 31, 1985.

Code Section 49(d)(1) and (2) could be read to mean that if a taxpayer is permitted a 10% ITC with respect to pre-1986 QPEs, then the portion of the basis of property attributable to these pre-1986 QPEs must be reduced by 10%. An alternative reading of Code Section 49(d)(1) and (2) would require the taxpayer to reduce the portion of the basis of property attributable to pre-1986 QPEs by only 5%.[4/]

The 1987 current year business credit attributable to ITC for the Transition Property placed in service in 1987, under Code Sections 38(a)(2) and (b)(1), is 8.25%[5/] of the cost of the 1987 Transition Property. Code Sections 46(a)(1), 46(b)(1), 49(c)(3)(A), 49(c)(5)(A) and 49(c)(5)(B)(i). In this case, it appears but is not certain that the basis of this property for purposes of determining the depreciation deduction allowances and gain or loss from the sale or other disposition of the property would be reduced by 10%.[6/] Code Sections 49(d)(1)(A), 48(q)(1), 168(a), 167(a), 167(g), 1011(a) and 1016(a)(22).

The ITC attributable to the 1985 property and the 1986 Transition Property, including that portion attributable to QPEs, which is carried forward to 1987, as permitted under Code Section 38(a)(1), must be reduced by 17.5%.[7/] Code Sections 49(c)(3)(B), 49(c)(5)(A) and 49(c)(5)(B)(i). There is no provision in the Code for a commensurate and concurrent upward adjustment in 1987 to the basis of this 1985 property and 1986 Transition Property to reflect this 17.5% reduction in allowable ITC.

The 1988 current year business credit attributable to ITC for the Transition Property placed in service in 1988, under Code Sections 38(a)(2) and (b)(1), is 6.5%[8/] of the cost of the 1988 Transition Property. Code Sections 46(a)(1), 46(b)(1) and 49(c)(1). Once again, it appears that the basis of this property, for purposes of determining the depreciation deduction allowances and gain or loss from the sale or other disposition of the property, would be reduced by 10%.[9/] Code Sections 49(d)(1)(A), 48(q)(1), 168(a), 167(a), 167(g), 1011(a) and 1016(a)(22).

The 17.5% reduction required in 1987 to the amount of (i) allowable ITC carryforward attributable to the 1985 property and the 1986 Transition

Property, including that portion attributable to QPEs, and (ii) the 1987 current year business credit attributable to the 1987 Transition Property, must be added back when these amounts become carryforwards to 1988. Code Section 49(c)(4)(B)(ii). These unexpired carryforwards to 1988 must then be reduced by 35%. Code Section 49(c)(2).

In 1988, therefore, the amount of ITC allowable with respect to the 1985 property, the 1986 Transition Property, including that portion attributable to QPEs, and the 1987 Transition Property is 6.5%[10/] of the cost of each of these properties. There is no provision in the Code for a commensurate and concurrent upward adjustment in 1988 to the basis of these properties to reflect this 35% reduction in allowable ITC.

In 1989, the amount of ITC allowable with respect to these properties remains reduced by 35%, under Code Sections 49(c)(1) and (2), and is, therefore, 6.5%[11/] of the cost of each of these properties. Once again, there is no provision in the Code for an upward adjustment in 1989 to the basis of these properties to reflect this 35% reduction in allowable ITC.

The following chart illustrates the above discussion:

Type of Property	Adjustment to Basis Required by Code Section 48(q)(1) and 49(d)(1)(A)	Percentage of the Cost of the Property that is Allowable as ITC under Code Section 38(a) for the Indicated Taxable Year ("% of ITC Allowed")			
		1986	1987	1988	1989
1985 property	5%	10%	8.25%	6.5%	6.5%
1985 QPEs attributable to 1986 Transition Property	5% or 10%	10%	8.25%	6.5%	6.5%
1986 Transition Property, not including that portion attributable to 1985 QPEs	10%	10%	8.25%	6.5%	6.5%
1987 Transition Property	10%*	N/A	8.25%	6.5%	6.5%
1988 Transition Property	10%*	N/A	N/A	6.5%	6.5%

* This would appear to be the amount based on a literal reading of Code Sections 49(d)(1)(A) and 48(q)(1).

II. Application of Legislative History of 1986 Act

While little guidance is available under the amended Code itself, the legislative history to these provisions does provide some additional information concerning the reduced investment tax credit and the basis reduction rules.

Section 211 of the Conference Committee Report No. 99-841, September 18, 1986, on the Tax Reform Act of 1986 (the "Report") explains Code Section 49 differently than a literal reading of that section. The Report states:

> A taxpayer is required to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of investment credits earned with respect to the transition property (after application of the phased in 35-percent reduction, described below).

(Emphasis added).

Shortly thereafter, the Report also provides:

> As described above, a full basis adjustment is required with respect to the reduced amount of the investment tax credit. Thus, for transition property that is eligible for a 6.5 percent investment tax credit, the basis reduction would be with respect to the 6.5 percent credit, not the unreduced 10 percent credit.

(Emphasis added).

Although this language does provide some guidance, it raises several more questions than it answers. In applying this language and the language of Code Section 49 to the situation of property being placed in service in different years as set forth earlier in this statement, it appears that several conclusions are possible.

For example, the adjustment to basis provision may not have been intended to apply to non-Transition Property since the first quote above states that it is applicable to Transition Property only. This coincides with Code Section 49(d)(1) which states that it applies "with respect to transition property."

Even though the statutory language is not clear, the Report is clear that the 35-percent reduction is applied in full for all years to the basis of property placed in service in 1988 and beyond. The Report also makes clear that the basis of property placed in service in 1986 is reduced by a full 10% in 1986.

Several interpretations exist when one applies the Report language to the ITC attributable to property placed in service in 1986 which is carried forward, as permitted under Code Sections 39(a)(1) and 38(a)(1), to 1987, 1988 and 1989. This is also true for ITC attributable to property placed in service in 1987 that is carried forward to 1988 and 1989, and with respect to the current year business credit allowed under Code Section 38(a)(2) for property placed in service in 1987.

We will first discuss the interpretations with respect to property placed in service in 1986 but with respect to which the ITC is carried forward. There is no definition in the Report of the word "earned", as used in the first cite set forth above. Additionally, there is no explanation of what "earned, after application of the phased in 35-percent reduction" means, or whether these terms are to be read together. With respect to the second cite set forth above, one is uncertain of the meaning of the word "eligible," as used therein, since such term has not been defined in the Report.

One could understandably interpret the Report, with respect to property placed in service in 1986 but with respect to which the ITC is carried forward, to mean that when a credit is carried forward to 1987, the taxpayer has either (i) earned, (ii) earned, after application of the phased in 35-percent reduction, or (iii) is eligible for, either a (x) 10% or (y) 8.25% ITC. When the credit is carried forward to either 1988 or 1989, the possible interpretations are either a (x) 10%, (y) 8.25%, or (z) 6.5% ITC. This is illustrated below.

1986 Transition Property not including that portion attributable to QPEs	1986	1987	1988	1989
Possibilities with respect to % of Adjustment to Basis	10%	10% or 8.25%	10% or 8.25% or 6.5%	10% or 8.25% or 6.5%
% of ITC Allowed	10%	8.25%	6.5%	6.5%

Similar alternatives would apply with respect to property placed in service in 1987.

III. Clarification of Statutory Law and Amendments to Conform to Historical Law

We believe that Code Section 49 should be revised so as to reflect the intent of the drafters as set forth in the Report language. Such revision would require taxpayers to reduce the basis of Transition Property in the year it is placed in service by the same percentage of ITC which would have been allowed in that year if the ITC had been utilized. In addition, we believe that the basis of the Transition Property should be increased by the amount of any subsequent reduction of allowable ITC; such increase would be effective as of the year in which such reduction became final, such as when the ITC is ultimately used in a carryforward year. This conforms with the historical interplay between the amount of ITC allowed and the basis reduction required. Finally, in order to treat different taxpayers fairly, an upward adjustment in basis should also be permitted for non-Transition Property as the ITC which is attributable to it is reduced under Code Section 49.

IV. Historical Treatment of ITC and Basis Adjustment

These basis adjustment proposals can be supported by prior legislation which dealt with similar problems concerning the interplay between ITC utilization and basis adjustment.

A. The 1962 Act

The Revenue Act of 1962, Pub. L. 87-834, 76 Stat. 960 (the "1962 Act") first enacted an ITC in the amount of 7% of the qualified investment. Section 46(a) of the Internal Revenue Code as in effect in 1962 (the "1962 Code"). Section 48(g)(1) of the 1962 Code required taxpayers to reduce the basis of property with respect to which ITC was allowed by 7%. Such basis, however, had to be increased under Section 48(g)(2) of the 1962 Code whenever a portion of the ITC initially allowed was subsequently disallowed because the property ceased to be a qualified investment or was disposed of before a predetermined period. The basis adjustment had to be made immediately before the event necessitating the adjustment occurred, and had to be made only to the extent ITC was disallowed.

B. The 1964 Act

Section 203(a)(1) of the Revenue Act of 1964, Pub. L. 88-272, 78 Stat. 19 (the "1964 Act") repealed the 7% basis reduction referred to above. Section 203(a)(2)(A) of the 1964 Act required taxpayers to increase the basis of property placed in service before January 1, 1964, "under regulations prescribed by the Secretary of the Treasury or his delegate, by an amount equal to 7 percent of the qualified investment with respect to such property," and if there had been, "any increase with respect to such property under section 48(g)(2) of such Code, the increase under the preceding sentence shall be appropriately reduced therefor."

Income Tax Regulation Section 1.48-7(d)(1) explains that the increase in basis is tied directly to the amount of ITC previously allowed; that is, the increase shall not be "in excess of the net reduction in basis under section 48(g)." This Regulation Section then goes on to explain that the basis adjustment is taken into account for purposes of future depreciation allowances, such that "the total depreciation allowances made during the remaining useful life of the property, plus the allowances for the expired useful life, will equal or approximate the allowances which would have resulted if section 48(g)(1) had not applied."

C. The 1982 Act —

The original concept of a reduction in the depreciable basis of property to take account of the ITC returned to the Code in 1982. Section 205(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 323 ("TEFRA") added a new Section 48(q) to the Code requiring taxpayers to reduce once again the basis of property with respect to which ITC is allowed by 50% of the ITC allowed. Code Section 48(q)(2) also allowed taxpayers an upward adjustment in basis immediately prior to the early disposition of property equal to 50% of the amount that must be recaptured by the taxpayer because such early disposition results in a portion of ITC being disallowed. This increase in basis maintains the initial numerical relationship between the ITC allowed and the basis reduction, such that the basis is never reduced by more than 50% of the ITC used. Similarly, if a credit for which a basis adjustment was required expires at the end of the carryover period, a deduction is allowed for one-half of the unused credit.[12]

Code Section 49(q)(4), which was added by TEFRA, further illustrated Congress' intent that the amount of the basis reduction should be directly tied to the amount of ITC allowed and eventually used. Under this section, a taxpayer has the option to reduce the amount of ITC allowed in lieu of reducing the basis of property.[13]

If QPEs were incurred prior to 1983 on property that was not placed in service until after 1983, the basis of the property attributable to the QPEs was not required to be reduced even though the remaining portion of the property was subject to the new basis reduction law. See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at page 37.

V. Conclusion

The legislative history shows that in the past whenever a taxpayer was required to reduce the amount of ITC allowed to him, he was permitted a commensurate upward adjustment in the basis of the property. This will not be true with respect to ITC carryforwards after July 1, 1987, unless Code Section 49(c) is amended in a manner similar to the proposed technical amendment set forth in the appendix.

Additionally, the percentage of basis reduction of ITC property has never been in excess of the percentage of ITC allowed. This will become the case, however, for the first time in the history of the ITC if the proposed technical amendment, or a similar amendment, relating to carryforwards is not made to Code Section 49(c).

It is also unfair at this point to require taxpayers to reduce the portion of basis attributable to QPEs incurred prior to the change in law by a full 100% of the amount of credit taken rather then the prior 50% amount. When taxpayers incurred QPEs prior to the change in law, they had a choice at that time either to make an election under Code Section 48(q)(4) to reduce the amount of credit but maintain the full basis for depreciation purposes, or to take the full credit and reduce their basis by 50% of the amount of the credit. A taxpayer's decision between these two choices was undoubtedly made by comparing the economic effect of each choice.

For those taxpayers who chose the latter alternative because it was economically more beneficial to them, it is now unfair to require them to reduce this portion of basis by 100%, since they were not aware of this at the time they had to make the aforementioned economic decision. If certain taxpayers had known of this change in law when they made their decision, they would have no doubt opted for a Code Section 48(q)(4) election which would economically be more beneficial in most cases after implementing this change in the law.

A Christian Retirement and Health Care Community

3001 Lititz Pike • P.O. Box 5093 • Lancaster, PA 17601 • (717) 569-2657

July 23, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

The purpose of my letter is to express concern regarding the potential taxation of charitable gift annuities as it may be affected by the Technical Corrections Bill (S.1350) now before the Senate Finance Committee.

Gift annuities are critical to the ongoing work of Brethren Village, a non-profit health care and retirement community in Lancaster, Pennsylvania. In the last 30 months alone, 78 donors have contracted almost $500,000 in gift annuities with us. The principal of most of these is designated for endowment upon the annuitant's death. Most of our annuitants have a long-standing interest in our community; many volunteer their time here or support our efforts in other ways. For them, the gift annuity is yet another way to express commitment to our mission to serve the aging. For most of our donors who are of average means, the gift annuity compares to the more affluent individual's charitable remainder trust which is unaffected by the IRS sec. 501(m).

Our charitable gift annuities do not seriously compete with commercial annuities. We do not market them heavily as do commercial companies, nor do we devote a substantial portion of our budget to their promotion. Our gift annuities are handled primarily by one, part-time officer who also has other responsibilities. Unlike many commercial-type insurance vehicles, charitable gift annuities primarily and irrevocably benefit a non-profit purpose.

Brethren Village was founded 90 years ago. The land and its first building were funded by an annuity. The concept of donors making substantial monies available in return for modest interest payments has been a integral part of our ability to offer continuous, fine care to the aging. Our $2 million endowment lets us plan our future, but the promise of $1,120,000 more in as-yet-unrealized annuity principal gives us the security to lay a course of excellence.

Changes in the tax regulations governing gift annuities which would affect our tax exempt status would affect most adversly the aging whom we serve. Increased tax liability would necessitate fee escalations and possibly cause us to limit services essential to the quality of life our residents deserve.

Brethren Village, as a sponsor of the Committee on Gift Annuities, would appreciate your leadership of the Senate Finance Committee in clarifying the exemption of gift annuities in the Technical Corrections Bill (s.1350).

Thank you for your support and understanding of this important issue.

Sincerely,

Gary N. Clouser, NHA
President

GNC:jh

8216 Rolling Meadows Drive
Hobbs, New Mexico 88240
September 5, 1987

THE SENATE FINANCE COMMITTEE
Laura Wilcox, Hearing Clerk
205 SDOB
Washington, D.C. 20510

RE: Technical Corrections Bill S1350
Amendment to TRA-86

Dear Mrs. Wilcox,

As a hard-working writer trying to succeed in an already difficult profession, I ask that you record my request as being against the proposed Technical Corrections Bill S1350, and strongly request the senators and representatives reconsider the situation and vote accordingly, clarifying it so free-lance writers' expenses in researching and writing are not subject to capitalization regulations.

They are proposing an almost impossible task, as well as an unfair one.

Thank you for your time.

Sincerely,

Patricia M. Breyman

Patricia M. Breyman

BROBECK, PHLEGER & HARRISON

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July 17, 1987

Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, DC 20510

Re: Technical Corrections Bill of 1987 (S. 1350)

Dear Ms. Wilcox:

Enclosed are five (5) copies of the comment pertaining to the application of the $200,000 limit on the compensation that may be taken into account under a qualified plan to a highly compensated employee where a member of his family works for the same employer. Also enclosed is a one-page summary.

Very truly yours,

David S Foster

David S. Foster

Enclosures

DEFINITION OF HIGHLY COMPENSATED EMPLOYEE

$200,000 LIMIT

Description of Provision

Section 1114(a) of the Tax Reform Act of 1986 added Section 414(q) to the Code, defining the term "highly compensated employee." Section 414(q)(6) provides that if an individual is a member of the family of a 5-percent owner or of a highly compensated employee in the group consisting of the 10 highly compensated employees paid the greatest compensation during the year, then such individual shall not be considered a separate employee, and any compensation paid to such individual shall be treated as if it were paid to the 5 percent owner or highly compensated employee. The provision did not state for what purpose the rule applies.

Section 111(j)(2) of the Technical Corrections Bill of 1987 would amend Section 414(q)(6) by adding a new subparagraph (C), clause (i) of which would provide:

> "Except as provided in regulations and in clause (ii), the rules of subparagraph (A) shall be applied in determining the compensation of (or any contributions or benefits on behalf of) any employee for purposes of any section with respect to which a highly compensated employee is defined by reference to this subsection."

Section 111 (d)(4) of the Technical Corrections Bill would amend Section 401(a)(17) by adding at the end thereof the following new sentence:

> In determining the compensation of an employee, the rules of section 414(q)(6) shall apply, except that in applying such rules, the term 'family' shall include only the spouse of the employee and any children of the employee who have not attained age 19 before the close of the year."

Problem

The proposed provisions create two different types of penalties, a tax penalty and an economic penalty:

1. Tax Penalty. Treating married persons who work for the same employer as one person for purposes of the $200,000 limit is a significant marriage penalty which is not justifiable on tax policy grounds.

Presumably, the fear is that, in the absense of these provisions, one spouse whose true compensation is over $200,000 will divert a portion of his true compensation to his spouse or minor child in order to avoid the $200,000 limit. This is a valid concern. However the means chosen to deal with the concern is inappropriate.

There are in fact situations where the members of a family unit are each paid their true compensation, even though they work for the same employer, and even though their aggregate compensation exceeds $200,000. The effect of the proposal would be to discourage marriage by coworkers and to discourage spouses from working for the same employer.

There are other ways of assuring that the compensation of one family member is not diverted to another. And even if no other way was available, the proposed solution would still be worse than the abuse. For every small businessman who puts his wife and children on the payroll without asking them to perform any duties, there are hundreds of bona fide situations where executives of a large corporation decide to marry each other.

2. Economic Penalty. Married persons who work for the same employer (who maintains a qualified plan) and jointly make over $200,000 will automatically have their compensation reduced. Their employer will make smaller contributions to defined contribution plans and pay smaller benefits out of defined benefit plans.

Every employer who maintains a qualified plan should respond by adopting a supplemental nonqualified plan to counteract the discrimination. This places a tremendous burden on the United States economy, far outweighing the magnitude of the problem. Moreover, in many cases the nonqualified plan would have to be funded, resulting in substantial additional costs on employers in order to make their married employees come out even.

Since the burden is so much greater than the problem, one can anticipate that employers will not adopt the supplemental nonqualified plans, and the burden will be on the employees either not to marry, or to work for different employers. The only alternative is to work for less aggregate compensation.

Proposed Solution

Each person should be treated separately for purposes of the $200,000 limit.

LAW OFFICES
BROWNSTEIN ZEIDMAN AND SCHOMER

July 23, 1987

(202) 879-5840

Senate Finance Committee
c/o Ms. Laura Wilcox and
c/o Ms. Mary McAulisse
Room 205
Dirksen Senate Office Building
1st and C Street, N.E.
Washington, D.C. 20510

Dear Ms. Wilcox and Ms. McAulisse:

Re: Low-income housing credit comments

In order to qualify as a "low-income unit", section 42(i)(3) of the Internal Revenue Code of 1986, as amended ("Code"), provides that an apartment must be occupied by a qualifying tenant and must be "rent-restricted". A "rent-restricted" unit is one in which the tenant does not pay more than 30 percent of a specified income ceiling, that is, 30 percent of 50 percent of area median income or 60 percent of area median income, as applicable, (the "income ceiling") adjusted for family size. Code Section 42(g)(2)(A).

Section 236 of the National Housing Act ("Act") was enacted for the purpose of reducing rentals for lower income families by authorizing the Secretary of Housing and Urban Development ("Secretary") to make periodic interest reduction payments on behalf of the owner of a rental housing project designed for occupancy by lower income families. The payments are made to mortgagees holding mortgages that meet the special requirement of Act Section 236.

As a condition for receiving the benefits of interest reduction payments, the project owner must operate the project in accordance with requirements imposed by the Secretary regarding tenant eligibility and rents.

For each dwelling unit, the owner must establish (with the approval of the Secretary) (A) a basic rental charge determined on the basis of operating the project with payments of principal and interest due under a mortgage bearing interest at the rate of 1 percent per annum; and (B) a fair market rental charge determined on the basis of operating the project with payments of principal, interest, and mortgage insurance premium which the mortgagor is obligated to pay under the mortgage covering the project. The rental of each dwelling unit will be at the basic rental charge or such greater amount, not exceeding the fair market rental charge, as represents 30 percent of the tenant's adjusted income. Act Section 236(f).

It should be noted that Act Section 236(f)(1) may conflict with Code Section 42(g)(2)(A). Under Code Section 42(g)(2)(A) a tenant cannot pay more than 30 percent of the income ceiling. Section 236(f)(1) provides that an owner must charge the basic rent or, <u>if greater</u>, 30 percent of the tenant's adjusted income (but never to exceed the fair market rent). No authority is given to charge less than the basic rent.

Under Act Section 236(f)(1), there will be times when the basic rent charged to a low income tenant exceeds the income ceiling under the Code's low-income credit provisions.

However, under Act Section 236(f)(1), there is no authority to reduce the amount of basic rent charged to a tenant and HUD will not permit variation in the amount of basic rent charged among similar sized units in a dwelling is permitted. The result is that a unit occupied by low income tenants who are paying basic rents under the HUD 236 program may not qualify for the low income credit because the basic rent exceeds 30 percent of the income ceiling. A conflict between two Federal statues exists.

A periodic determination is made as to the amount of basic rent to be charged. Since increases in basic rents charged to tenants by reason of increases in operating and maintenance costs must be approved by the Secretary, abuses are not likely.

Unless relief is provided, an owner receiving basic rents from low-income tenants may not be able to include those units in a building's qualified basis under the low-income housing credit provisions, regardless of the otherwise low-income character of the units, effectively making the low-income credit provisions meaningless in projects receiving assistance under Section 236. This problem can be solved by amending the statute to include in the definition of a "rent-restricted" unit a unit on which a tenant pays no more than the basic rent under Act Section 236.

Precedent for amending the low-income credit provisions to resolve conflicts with other Federal statutes is found in the proposed Technical Corrections Act of 1987 which permits gross rent to exceed income limitations if, inter alia, Federal rental assistance payments are made with respect to the unit or its tenants. Were the Act Section 236 payments Federal rental assistance payments instead of Federal interest subsidy payments, relief would be available under this proposed amendment to Code Section 42(g)(2). Since the result of the interest subsidy is to reduce rental payments by low-income tenants, relief similar to that provided under proposed Code Section 42(g)(2)(B) should be extended to projects receiving Act Section 236 basic rent payments.

We will be pleased to work with you in drafting appropriate legislative language.

Very truly yours,

Kyllikki Kusma

Kyllikki Kusma

1660k

BRYAN COLLEGE

Christ Above All

July 14, 1987

Ms. Laura Wilcox
US Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

Please exclude charitable gift annuities from the Technical Corrections Act of 1987 (HR 2636) by amending this bill to state that charitable gift annuities issued by IRC Sec. 501 (c) (3) organizations are not "commercial-type insurance" under IRC Sec. 501 (m).

The primary motive of a donor who invests in charitable gift annuities is to make a gift to charity while retaining a life income interest. In this way annuities are no different than charitable remainder annuity trusts which are preferred by those making larger gifts.

Charitable gift annuities have been used by charitable organizations for over 100 years and provide the donor of limited means a way to make a small charitable remainder gift.

Failure to amend or clarify this law would jeopardize an important source of funds for all charities.

Please take up this matter on behalf of the many charitable causes and urge your colleagues to do the same. We appreciate your help in this important matter.

Sincerely,

Kenneth G. Hanna

Dr. Kenneth G. Hanna
President

KGH:es

78-959 754

BOX 7000 • DAYTON, TENNESSEE 37321-7000 • (615) 775-2041

COMMENTS ON S.1350,

THE TECHNICAL CORRECTIONS ACT OF 1987

PRESENTED TO THE COMMITTEE ON FINANCE

U.S. SENATE

BY RAYMOND T. SCHULER, PRESIDENT

THE BUSINESS COUNCIL OF NEW YORK STATE, INC.

JULY 16, 1987

The Business Council of New York State, Inc. is the largest broad-based business group in New York State, representing over 3,500 companies and nearly 200 local and regional chambers of commerce from throughout the State. The following comments detail initiatives which we strongly support as vital to meeting the future energy needs of Long Island.

S.1350, the Technical Corrections Act of 1987, contains a provision (amending section 1316 (g)(8) of the 1986 Tax Reform Act) that allows the New York Power Authority to issue bonds under the state's tax-exempt bond volume limitation cap using carryforward provisions.

The 1984 Deficit Reduction Act and the Tax Reform Act of 1986 authorized the Power Authority to issue up to $911 million in tax exempt bonds within the limits of the annual state cap. The Technical Corrections Act contains a provision that will allow the Authority to carryforward state authorized bonding allocations and thereby assure New York's maximum use of it's federally prescribed limit.

One of the projects to be financed through the issuance of the bonds provided through the 1984 and 1986 Acts is a 345 - kilovolt underground and underwater transmission cable from Westchester to Long Island. The cable is designed to increase the reliability of Long Island's power supply by nearly doubling the capacity of its transmission ties to neighboring electric systems.

Another correction needs to be made in addition to the future carryforward ability provided in the bill. The carryforward election for the Long Island Cable Project made by the Power Authority in 1985 apparently does not meet the criteria contained in the 1986 Act necessary to be considered an eligible carryforward. The construction of the cable is essential to economic health of the ratepayers of Long Island, who currently pay some of the highest electric rates in the nation. Without additional language specifying that the carryforward is eligible, New York faces the loss of $106.5 million for this essential project.

The Business Council of New York State, Inc. appreciates your efforts in obtaining language in S.1350 which clarifies the prospective use of the carryforward provision for Power Authority bonds. In addition, we are hopeful that language will be added to the bill which will preserve the $106.5 million in carryforward previously elected for the Long Island Sound Cable project.

We appreciate your consideration of our comments.

BURLINGHAM UNDERWOOD & LORD
ONE BATTERY PARK PLAZA
NEW YORK, N.Y. 10004

EUGENE UNDERWOOD
COUNSEL

July 23, 1987

Senate Committee on Finance
United States Senate
Room S.D. 205
Dirksen Senate Office Building
Washington, D.C. 20510

Attention: Laura Wilcox, Hearing Administrator
Mary McAutiffe, Minority Chief of Staff

(A one-page summary of the proposals below is attached at the end of this letter)

Dear Committee Members:

Pursuant to your invitation for public comment on the Technical Corrections Bill of 1987 (S. 1350) (the "TCB"), the undersigned* is pleased to submit its comments with respect to Section 112(e) of the TCB as it pertains to the proposed broadening of the so-called "publicly-traded" exception to the "shareholder look-through" provisions of Section 883(c)(1) of the Internal Revenue Code of 1986 (the "Code").

The comments submitted below suggest a further broadening of the "publicly-traded" exception, consistent with with the Congressional objective and intent of denying the benefit of the Section 883 tax exemption to publicly-traded foreign corporations organized in foreign countries that do not grant reciprocal exemptions to U.S. corporations. The comments below also suggest modifications to Section 883 that more fully reflect the foregoing Congressional objectives and intent without discriminating against publicly-traded foreign corporations that should otherwise be eligible for the benefit of Section 883.

I. General Background to Comments.

A. Changes Made by Tax Reform Act of 1986.

The Tax Reform Act of 1986 ("TRA") made several significant changes in the manner in which the United States taxes foreign shipping corporations trading to the United States which can be briefly summarized as follows:

(1) The 4 Percent Gross Basis Tax. A new 4 percent "gross" basis tax was imposed by Section 887 on "United States source gross transportation income"1/ of foreign corporations derived from the operation of vessels to the United States.

(2) Narrowing of Reciprocal Exemption. The exemption of foreign shipping corporations from tax as granted by Section 883 was narrowed by changing the criteria for exemption from a "flag" test to a "residence" based test which essentially requires: (i) the foreign corporation to be incorporated in a "qualifying"2/ country (the "Country of Incorporation Test") and (ii) more than 50 percent of the value of the foreign corporation's stock to be beneficially owned by individuals residing in one or more "qualifying" foreign countries (the "Shareholder Look-Through Test").

(3) Publicly-Traded Exception. An exception to having to satisfy the Shareholder Look-Through Test was carved out by Congress under Section 883(c)(3) for foreign corporations whose stock (or that of its ultimate parent) was primarily and regularly traded on an established securities market in the foreign corporation's country of incorporation.

The legislative background and apparent rationale for this so-called publicly-traded exception and our proposals for further expanding said exception beyond that which is proposed by Section 112(e) of the Bill is discussed in Section II. below.

B. Principal Impetus for TRA Changes.

(1) The 4 Percent Tax. The principal impetus behind the 4 percent tax was to give "like kind" tax treatment to foreign corporations and individuals conducting shipping operations out of certain "non-qualifying" countries in the Far East (India, Indonesia, Malaysia, Pakistan, Phillipines and Singapore) and in South American (Venezuela) which countries have persisted, despite protests from the United States, in imposing freight or other comparable taxes on U.S. corporations and citizens engaged in shipping operations to such countries.

(2) The Narrowing of Section 883 Exemption. The criteria for the Section 883 exemption was changed from a "flag" test to Shareholder Look-Through Test to prevent foreign corporations and individuals located in "non-qualifying" countries from obtaining the benefit of such exemption merely by registering the vessel, which generated the shipping income, under the "flag" of a "qualifying" country (i.e. comparable to third-party use of tax treaties).

(3) Overall Congressional Objective. The overall objective of Congress in enacting the 4 percent tax and narrowing of the Section 883 exemption was to bring sufficient economic pressure on the foreign shipping corporations based in "non-qualifying" countries such that most, if not all, of the non-qualifying countries would enter into an exchange of notes with the United States which would grant the desired reciprocal exemption from tax to U.S. corporation and citizens.

II. Publicly Traded Exception - The Underlying Rationale.

A. House Bill.

The publicly-traded exception first appeared in the House's Tax Reform Bill (H.R. 3838). Its scope, however, was limited to a "first level" foreign shipping corporation that was the actual operating corporation. The availability of the exception was further limited by requiring that the stock of the foreign corporation had to be primarily and regularly traded on an established securities market in the foreign country in which such corporation was incorporated ("Trading-Incorporation Linkage".)

The House Ways and Means Committee Report ("House Report") gave no specific underlying rationale for the publicly-traded exception. However, it seems apparent that the concept of this type of exception was inserted out of concern for the administrative and procedural difficulty to be faced by a publicly-traded corporation in obtaining and verifying the identity of the ultimate "individual" beneficial owners and the "residence" of such owners, the two principal factors required to determine whether or not the Shareholder Look-Through Test has been satisfied.

B. Senate Bill.

The publicly-traded exception was expanded in the Senate's Tax Reform Bill to encompass an additional variation -- that being where the ultimate parent of the foreign shipping corporation was the publicly-traded entity. However, the Senate Bill not only adopted, as to the publicly-traded parent itself, the Trading-Incorporation Linkage approach of the House Bill but in addition, it also required that such parent and its wholly-owned subsidiary had to be incorporated in the same country ("Parent-Subsidiary Incorporation Linkage").

C. Conference Bill.

The Conference Bill, which ultimately became the TRA, adopted the Senate Bill's expanded version of the publicly-traded exception. While The Conference Report makes no mention of the publicly-traded exception, the general explanation of the TRA as prepared by the Staff of the Joint Committee on Taxation (the "Blue Book") specifically recites that the underlying Congressional rationale for the publicly-traded exception was that "a corporation whose stock is publicly-traded primarily in the country of organization should be presumed to be owned by local residents" and accordingly, such corporations "should be exempt from tax as long as the corporations are organized in a country that does not tax" U.S. corporations and citizens (Blue Book, p. 928).

III. Specific Comments and Proposals With Respect to Section 112(e) of the TCB.

A. The Publicly Traded Exception -- Support For Current Proposal.

Under Section 112(e) of the TCB, the publicly-traded exception is expanded by severing the Parent-Subsidiary Incorporation Linkage (i.e. the publicly-traded parent would no longer need be incorporated in the same country as its wholly-owned subsidiary but only in a "qualifying" country).

We support the expansion of the publicly-traded exception as currently proposed by Section 112(e).3/ However, we believe the exception should be further expanded to more fully reflect the underlying intent and rationale of Congress in enacting the publicly-traded exception.

B. Proposals For Further Expansion of Publicly-Traded Exception.

(1) Elimination of Parent-Subsidiary Ownership Linkage. As stated in Section III.A., the apparent rationale of the House in adopting the publicly-traded exception in the first instance was out of concern for the administrative and procedural difficulties that a publicly-traded corporation would have to face in satisfying the Shareholder Look-Through Test (i.e. being able to determine and verify the identity and residence of the ultimate beneficial individual owners of its stock).

In view of this fact, there is no apparent rationale for denying a foreign corporation the benefit of the publicly-traded exception merely because its stock is not "wholly-owned" by a single publicly-traded corporation as currently required instead of, for example, by two or more publicly-traded corporations.

The foregoing inequity could be remedied by adoption of the following proposal:

Proposal No. 1. The words "one or more corporations" should be inserted in lieu of the word "another corporation" in subparagraph (B) of the proposed technical amendment to Section 883(c)(3) as set forth in Section 112(e) of the TCB.

(2) Elimination of "Primarily" Requirement and Trading-Incorporation Linkage if All Stock is Traded in Qualifying Countries. The availability of the publicly-traded exception is contingent upon, inter alia, the stock of the relevant corporation being "primarily" (as well as "regularly") traded on an established securities market in the corporation's country of incorporation.

It is apparent that the underlying intent of the "primarily" requirement is to limit potential manipulation of the publicly-traded exception (i.e. listing stock in a "qualifying" country but having most of it traded in a "non-qualifying" country). However, there seems to be no purpose served by requiring a publicly-traded corporation to be needlessly burdened with the potential administrative and procedural hurdles of having to satisfy the "primarily" test if all its stock is regularly traded on one or more established securities markets located in "qualifying" countries. In this regard, we are of the view that in the absence of some overriding policy reason for wishing to discourage foreign corporations from listing their securities on U.S. stock exchanges, a "qualifying" country should also be deemed to include the United States.

We are also unaware of any policy reason for denying, as the current statute does, a foreign corporation the benefit of the publicly-traded exception merely because its country of incorporation has no established securities market. We are, for example, aware of at least one foreign shipping corporation whose stock is traded on the New York Stock Exchange that would be denied the benefit of the exception on this basis.

The foregoing suggestions could be implemented by adoption of the following proposal.

Proposal No. 2. A separate subparagraph (C) could be added to Section 883(c)(3) to provide that the requirements of subparagraph (A) shall be deemed to have been satisfied if all the stock of the foreign corporation is regularly traded on a securities market or markets established in one or more foreign countries qualifying for "equivalent exemption" status under Section 883(a) and/or in the United States.

C. The Shareholder Look-Through Test -- Establishing Statutory Presumption For Publicly-Traded Corporations.

A publicly-traded corporation which forms a foreign joint venture shipping corporation ("JVC") with one or more privately-held corporations (a not uncommon occurrence in the foreign shipping industry) is accorded no benefit whatsoever from the publicly-traded exception as currently drafted. Instead, it is left to face the administrative and procedural quagmire of the Shareholder Look-Through Test.

In our view, this results in an illogical and unwarranted discrimination against a publicly-traded corporation which forms a joint venture corporation with one or more privately-held corporations. It elevates form over substance and runs contrary to the underlying intention of the publicly-traded exception itself.

For example, in the situation where the stock of JVC is equally owned among: (i) a publicly-traded corporation which otherwise would qualify for the publicly-traded exception[4/] (ii) a privately-held corporation incorporated and wholly-owned by individuals residing in a "qualifying" country and (iii) a privately-held corporation incorporated and wholly-owned by individuals residing in a "non-qualifying" country, the publicly-traded corporation must trace a minimum of 51% of its stock ownership to individuals residing in "qualifying" countries in order for the "more than 50% stock value" threshold of Shareholder Look-Through Test to be met.[5/] This may prove to be an insurmountable task for the publicly-held corporation given the administrative and procedural difficulties involved in tracing ultimate individual ownership of its stock.

The inequity of this situation could be remedied by adoption of the following proposal:

Proposal No. 3. A new subparagraph (A) could be added to Section 883(c)(1) to provide that for purposes of applying the "shareholder look-through" provisions of Section 883(c)(1), all the publicly-traded stock of a corporation should be deemed to be beneficially owned by individuals who reside in the foreign country where the corporation is incorporated and its stock is primarily[6/] and regularly traded.[7/]

D. Specific Grant of Legislative Regulatory Authority.

To the extent Congress is concerned that our proposals for expanding the publicly-traded exception and establishing a presumption of individual beneficial ownership for publicly-traded corporations will result in their unintended manipulation, we would suggest that Congress grant the Secretary of Treasury legislative authority to prescribe such regulations as are necessary or appropriate to prevent any such unintended manipulation.

Our final proposal is therefore as follows:

Proposal No. 4. A new paragraph (5) could be added to Section 883(c) to grant Treasury with authority to issue such implementing regulations as are necessary or appropriate to carry out the purposes of the provisions applicable to publicly-traded corporations.

CONCLUSION

It is our belief that our proposals for expansion of the publicly-traded exception and the establishment of a presumption of individual beneficial ownership for publicly-traded corporation falling outside the scope of the exception are consistent with the original intention and objectives of Congress in enacting such exception and if accepted, will go far toward alleviating the difficult (and perhaps insurmountable) legal and practical hurdles facing Treasury and the Internal Revenue Service in enforcing the new 4% gross basis tax of Section 887 and administering the newly narrowed Section 883 exemption.

Sincerely,

Derick W. Betts, Jr., Chairman
Tax Subcommittee to Committee
on Marine Financing

Summary of Proposals

The intention of Congress in narrowing the Section 883 exemption from tax by the Tax Reform Act of 1986 was, inter alia, to deny the benefit thereof to foreign corporations organized and publicly traded in foreign countries that do not grant reciprocal exemptions to U.S. corporations.

The proposals set forth below attempt to suggest modifications to Section 883 that more fully reflect the foregoing intent without discriminating against publicly-held foreign corporations which should otherwise be eligible for the benefit of Section 883.

A. Proposal No. 1. To insert the words "one or more" in lieu of the word "another" in subparagraph (B) of the proposed technical amendment to Section 883(c)(3) as set forth in Section 112(e) of the TCB.

(a) Purpose: To permit two or more publicly-traded corporations, each of which would individually qualify for the publicly-traded exception, to claim the benefit of such exception where they jointly form a foreign shipping corporation in a country which grants reciprocal tax treatment to U.S. corporations (a "qualifying" country).

B. Proposal No. 2. To add a separate subparagraph (C) to Section 883(c)(3) to provide that subparagraph (A) shall be deemed to be satisfied if all the stock of the foreign corporation is regularly traded on a securities market or markets established in in one or more "qualifying" countries and/or in the United States .

(a) Primary Purpose: To allows foreign corporations to avoid the potential administrative and procedural hurdles of having to show the country in which its stock is "primarily" traded if none of its stock is traded in "non-qualifying" countries.

(b) Secondary Purposes: (i) to prevent a foreign corporation from being precluded from the benefit of the publicly-traded exception merely by virtue of the fact its country of incorporation does not have an established securities market; and (ii) to not discriminate against a foreign corporation which trades all or some of its stock on a U.S. securities exchange.

C. Proposal No. 3. To add a new subparagraph (A) to Section 883(c)(3) to provide that for purposes of applying the "shareholder look-through" provisions of Section 883(c)(1), all the publicly-traded stock of a corporation should be deemed to be beneficially owned by individuals who reside in the country where the corporation is incorporated and its stock is primarily and regularly traded.

(a) Purpose: To extend to publicly-traded corporations the presumption intended by Congress (Blue Book, p.928) and also, for example, accorded publicly-traded corporations by the Department of Treasury in Article 16 of its 1981 Draft U.S. Model Income Tax Treaty. The United States is not a "qualifying" country for purposes of satisfying the "primarily" test.

D. Proposal No. 4. To add a new paragraph (5) to Section 883(c) to provide that the Treasury be granted authority to issue such implementing regulations as are necessary or appropriate to carry out the purposes of the provisions applicable to publicly-traded corporations.

(a) Purpose: To give Treasury specific legislative power to prevent the unintended manipulation of the proposals made above with respect to publicly-traded corporations.

* The undersigned is the Chairman of the Tax Subcommittee to the Committee on Marine Financing of the Maritime Law Association of the United States ("MLA"). Since time constraints have prevented the circulation of this letter for the required approval by the MLA's Executive Committee, the comments and proposals set forth in this letter are being submitted by the undersigned on his behalf and on behalf of the other members of the Tax Subcommittee in their respective individual capacities.

1/ The amount of "U.S. source" transportation income potentially subject to the 4 percent tax was significantly expanded by the TRA as a result of Section 862(c)(2) being amended to provide that fifty (50) percent of all transportation incomed will be considered from "United States sources" where the relevant transportation activity takes place between the United States and another country. Previously, the U.S. source transportation income was calculated by reference to a vessel's expenses and time within U.S. territorial waters (i.e. three mile limit).

2/ The term "qualifying" is used herein to characterize any foreign country which by treaty, exchange of notes or internal law, grants U.S. corporations and citizens an exemption from tax equivalent to Section 883. The term "non-qualifying" is used herein in the reverse context.

3/ We also support the only other technical change made by Section 112(e) of the TCB -- that being to modify the reciprocal exemption provisions of Section 872(b) and Section 883(a) of the Code so that they operate independently with respect to nonresident alien individuals and foreign corporations.

4/ In other words, the corporation is incorporated in a "qualifying" country and its stock is primarily and reqularly traded on an established securities market in such country.

5/ The 50% threshold can only be met by combining the 33 1/3% ownership of JVC's stock attributable to the privately held corporation based in a "qualifying" country with a minimum of 17% (51% x 33 1/3%) stock ownership attributable to the qualifying individual shareholders of the publicly-held corporation.

6/ For purposes of Proposal No. 3, the United States is not a "qualifying" country for purposes of satisfying the "primarily" test.

7/ Establishing such a presumption would not only be fully consistent with the presumption intended by Congress to be given to publicly-traded corporations (see quoted excerpt from the Blue Book in Section II.C. above) but also, for example, with the presumption accorded publicly-traded corporations by Department of Treasury in Article 16 of its 1981 Draft U.S. Model Income Tax Treaty.

LAW OFFICES
BUTZ, HUDDERS, TALLMAN, STEVENS & JOHNSON

Ms. Mary McAuliffe
Minority Chief of Staff
United States Senate
Committee on Finance
Room SD-G08
Washington, D.C. 20510

Re: Technical Corrections Bill -
Provisions on Stripped Tax-Exempt Bonds

Dear Ms. McAuliffe:

The Technical Corrections Bill recently introduced in Congress to amend the Tax Reform Act of 1986 contains certain revisions to Section 1286(d) of the Internal Revenue Code that governs the tax treatment applicable to holders of stripped tax-exempt coupons or bonds. The proposed amendment, if adopted unchanged, has the potential to adversely affect all persons investing in such stripped coupons and bonds.

Under current law, investors who purchase stripped tax-exempt obligations in the secondary market at a yield in excess of the yield at which the unstripped bonds were originally issued are not required to recognize any portion of the resulting market discount as taxable income (capital gains for most taxpayers) until they sell the bond or it matures or is redeemed. This tax treatment is consistent with the treatment of unstripped tax-exempt bonds purchased at a market discount.

Section 118(n)(4) of the Technical Corrections Bill, if adopted unchanged, would effectively change that treatment, but only for stripped tax-exempt obligations. Persons who purchase stripped coupons or bonds after June 10, 1987 at a yield in excess of the yield at which the unstripped bond had originally been issued would be required to treat a portion of the resulting market discount as though it were taxable original issue discount. The investor would be required to recognize as ordinary income each year a portion of the accretion of such market discount.

For example, if X stripped a tax-exempt bond originally issued at a yield of 10% and sold a stripped coupon at 8% to Y, the entire discount would be treated as tax-free original issue discount to Y. If Y later sold this stripped coupon to Z at a 9% yield, Z would treat the entire discount produced by the 9% yield as tax-free original issue discount. However, if Y had been forced to sell the stripped coupon at a yield of 11%, Z would treat the resulting discount as a combination of tax-free and taxable original issue discount. Each year Z would be required to include in his taxable income a proportionate share of the total accreted discount for the year. This taxable portion would be calculated by multiplying the total accreted discount by a fraction, the numerator of which would be 1% in this case and the denominator of which would be 11%.

We understand that the staff of the Congressional tax-writing committees looked at the Internal Revenue Code language governing stripped taxable obligations (e.g., stripped Treasury Bonds or STRIPS) and used that as a guide to draft the proposed amendment. Each purchaser of a STRIP is required to treat the entire discount at which he purchases his STRIP as taxable original issue discount, even though a significant portion of that discount may have arisen from market volatility. The staff apparently assumed that, to be consistent, market discount arising in stripped tax-exempt obligations should be treated similarly to that arising in STRIPS.

This treatment would obviously be inconsistent with the tax treatment for unstripped tax-exempt bonds purchased at a market discount. It would also unfairly penalize investors who purchased stripped coupons or bonds prior to June 10, 1987 and thereafter wish to sell such items. The potential for an exaggerated decrease in value in a down market would likely both drive up required market returns and limit severely the number and types of investors who would be interested in these instruments.

We ask that the Senate Finance Committee revise the language of Section 118(n)(4)(A) of the Technical Corrections Bill to eliminate this inconsistency in treatment between stripped and unstripped tax-exempt obligations. We suggest that subparagraph (ii) of the proposed Section 1286(d)(1)(A), recited in Section 118(n)(4)(A) of the Bill, be modified to substitute the words "market discount" for the term "original issue discount" in such subparagraph (ii).

Please call the undersigned if you have any questions or require additional information. We will be pleased to discuss this matter with you or your colleagues at your convenience.

Very truly yours,

Jack J. Johnson

JJJ/pc

COMMENTS ON TECHNICAL CORRECTIONS BILL

SUMMARY STATEMENT

STRIPPED TAX-EXEMPT BOND PROVISIONS

Under current law, investors who purchase stripped tax-exempt obligations in the secondary market at a yield in excess of the yield at which the unstripped bonds were originally issued are not required to recognize any portion of the resulting market discount as taxable income (capital gains for most taxpayers) until they sell the bond or it matures or is redeemed. This tax treatment is consistent with the treatment of unstripped tax-exempt bonds purchased at a market discount.

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We ask that the Senate Finance Committee revise the language of Section 118(n)(4)(A) of the Technical Corrections Bill to eliminate this inconsistency in treatment between stripped and unstripped tax-exempt obligations. We suggest that subparagraph (ii) of the proposed Section 1286(d)(1)(A), recited in Section 118(n)(4)(A) of the Bill, be modified to substitute the words "market discount" for the term "original issue discount" in such subparagraph (ii).

CADILLAC PRODUCTS, INC.

COMMENTS ON THE PROVISIONS OF THE
TECHNICAL CORRECTIONS BILL OF 1987 (S.1350)
SECTIONS 102(d) AND 109(b) AMENDMENTS RELATING TO
SECTIONS 204 AND 902 OF THE TAX REFORM ACT OF 1986

Upon reviewing the Technical Corrections Bill of 1987 (S. 1350), it was noted that a major inequity exists which was not recognized in the Tax Reform Act of 1986 (TRA 86) nor in (S. 1350). Namely, those taxpayers who incurred casualty losses to their business property and who are in the statutory involuntary conversion replacement period during which TRA 86 was enacted, suffer a two-fold detriment in the case of depreciation and the investment credit. In addition, many of these taxpayers may lose certain tax benefits of Industrial Development Bond issues planned to refinance the replacement of business property lost by casualty.

Generally, Section 1033, IRC, provides that, "if property (as a result of its destruction in whole or in part, theft, seizure or a requisition or condemnation or threat of condemnation or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain or loss is recognized." If the property lost by casualty is converted into money, then, if within the statutory period provided, the taxpayer purchases other property similar or related in service or use to the lost property, then deferral of any gain is accomplished if the taxpayer so elects and timely purchases qualified replacement property. The replacement period for such casualties is two years after the close of the first taxable year in which any part of the gain upon the conversion is realized or at such later date as the IRS may designate upon application of the taxpayer.

Thus, under the involuntary conversion provisions of Section 1033, IRC, statutory concessions have been made to place the taxpayer in the same position as he was prior to a casualty without having to pay any tax on any gain realized on the conversion; providing such gain is reinvested in qualified replacement property. However, under the recapture of depreciation provisions of Sections 1245 and 1250, IRC, and the recapture of investment credit provisions under Section 47, IRC, a taxpayer suffering a casualty loss of business property is subject to depreciation and investment credit recapture taxes as a result of the involuntary conversion of property. The taxpayer, before enactment of TRA 86, would be able to take comparable depreciation methods and lives and investment credit on the replacement property as compared with the property lost. However, with the enactment of TRA 86, many taxpayers who are in the replacement period for casualty losses, suffer a double detriment in which they are subject to recapture taxes on property lost and also are faced with less advantageous depreciation write-offs on replacement property and the loss of the investment credit.

Some taxpayers planning an issue of Industrial Development Bonds to help finance the replacement of property lost through a casualty could also be detrimentally affected by certain provisions of TRA 86. TRA 86 continues, for a limited period, the small issue exemption from federal income tax for interest on qualified small issue Industrial Development Bonds. However, TRA 86 denies certain financial institutions a deduction for 100% of their interest expense allocable to buying or carrying tax-exempt obligations acquired after August 7, 1986. It is common practice for financial institutions to acquire, for their own account, entire issues of tax-exempt Industrial Development Bonds. If the interest income they receive on such bonds is, in effect, taxable, inasmuch as an equivalent amount of interest expense has been disallowed, then they will require a higher rate of return on their investment in such bonds.

An example is my employer, Cadillac Products, Inc., its subsidiaries and affiliated company, Cadillac-Ferndale, Inc. These companies lost a manufacturing plant at Terre Haute, Indiana on December 28, 1985. We are in the process of replacing this lost plant and equipment, etc. and expect to have it completed by December 31, 1988 (the expiration date of the statutory replacement period under Section 1033, IRC.) It is presently estimated that we will expend approximately $10,000,000 to replace the building and equipment and approximately $800,000 for the inventory lost in the fire. We also expended over $1,000,000 at our Rogers City, Michigan plant for equipment and modifications to replace plastic film capacity lost at Terre Haute and required to continuously supply our customer, General Motors Corporation. In addition, it is estimated that we will have lost net revenues of approximately $2,000,000 (after business interruption insurance of $1,000,000) which we had planned on utilizing in our business operations. We received $7,839,000 insurance reimbursement to cover the loss of our building, equipment and inventory. As a result of this shortfall in funds required, we have had to arrange a borrowing of $7,000,000 through an Industrial Development Bond issue of which we have received a commitment for the entire issue from Comerica Bank, Detroit, Michigan.

Provisions of TRA 86 (and the Technical Corrections Bill of 1987) which affect taxpayers, and specifically Cadillac Products, Inc., in their efforts to replace business property lost through casualty are:

1. Section 211, TRA 86, providing for repeal of the investment credit for any property placed in service after December 31, 1985. Transitional rules apply to written contracts binding on December 31, 1985 with such property being placed in service during periods from July 1, 1986 to January 1, 1991 depending on the ADR Midpoint Lives.

   Effect on taxpayers -

   Taxpayers, who are not included in TRA 86 transitional exemptions or binding contract exceptions, will not be eligible for the investmént credit on any funds expended on casualty loss replacement machinery and equipment purchased after December 31, 1985.

2. Section 201, TRA 86 -

   a. Any non-residential real and residential rental property financed by a tax-exempt bond issue (including Industrial Development Bonds) must use a depreciation recovery period of 40 years, straight line method, for property placed in service after December 31, 1986. Transitional rules apply to property constructed, reconstructured or acquired under a written contract binding as of March 1, 1986 and placed in service by January 1, 1991.

   b. Machinery and equipment with a 5 year recovery period remains at 5 years with 150% declining balance method increasing to 200% for property placed in service after December 31, 1986. There are no transitional rules relative to property with an ADR Midpoint Life less than 7 years.

Effect on taxpayers -

Those taxpayers suffering a casualty loss and without a binding written contract on replacement property as of March 1, 1986 and prior, with financing by tax exempt Industrial Development Bonds, must depreciate non-residential real property and residential rental property over 40 years, straight line method, instead of 19 years straight line method, under the law in effect prior to TRA 86. This same property, without financing through an Industrial Development Bond issue, will have a depreciation recovery period under TRA 86 of 31-1/2 years, straight line method.

3. Section 902, TRA 86, denies banks, thrift plan institutions and other financial institutions a deduction for 100% of their interest expense allocable to buying or carrying tax exempt obligations (including Industrial Development Bonds) acquired after August 7, 1986. Bonds acquired after August 7, 1986 are subject to the 20% interest expense disallowance rule for taxable years ending in 1986. Such bonds are, however, subject to the new 100% interest expense disallowance rule for subsequent taxable years.

Effect on taxpayers -

Those taxpayers suffering casualty losses and who were in the process of replacing their property within the statutory period provided by Section 1033, IRC, and who had not arranged Industrial Development Bond financing through financial institutions by August 7, 1986, find themselves in the position that financing costs (depending on location and market) will be an estimated additional 1-1/2 to 2-1/2%. Cadillac finds that its additional financing costs will be 1-1/2% on $7,000,000 of qualified small issue Industrial Development Bonds not placed with a financial institution by August 7, 1986.

We realize that TRA 86 provided transitional exemptions and exceptions for binding contracts in effect on certain dates as enumerated in the law. However, it can be readily appreciated that companies incurring disastrous business casualty losses and who are replacing property over the long period provided in Section 1033, IRC, could find themselves incurring a double detriment in that they must pay depreciation and investment credit recapture taxes on property lost through casualty and, yet, not receive equal benefits on replacment property due to the enactment of TRA 86. It would appear that relief should be provided for such taxpayers.

Therefore, it is respectfully requested that Cadillac's problem be favorably considered and that the following amendments be added to Sections 102(d) and 109(b) of (S.1350)

Section 102(d) . . . . (38) the amendments made by Section 201 shall not apply to . . . .

"(I) Cadillac Products Inc. and its subsidiaries and affiliated company in relation to the replacement of the building and equipment totally destroyed by fire at Terre Haute, IN on December 28, 1985 with a total replacement project cost of approximately $2,200,000 for the building and $7,800,000 for the machinery and equipment and approximately $1,000,000 of machinery and equipment at Rogers City, MI replacing manufacturing capacity lost at Terre Haute, IN."

Section 109(b)(1) - Paragraph (3) of Section 902(f) of the Reform Act is amended --

. . . .

(D) By adding at the end thereof the following new paragraphs:

. . . .

"(W)Cadillac Products Inc. and its subsidiaries and affiliated company, plant and equipment replacement relating to the total loss by fire of the manufacturing plant at Terre Haute, IN on December 28, 1985."

We shall be pleased to furnish any other information desired in connection with this matter.

Respectfully submitted,

CADILLAC PRODUCTS, INC.

Albert H. Giuliani,
Treasurer

CADILLAC PRODUCTS, INC.

SUPPLEMENTAL SHEET

1) Name, address, telephone number of company officer and designated representative.

a) Albert H. Giuliani, V.P. Finance-Treasurer
Cadillac Products, Inc.
500 Stephenson Highway, Suite 410
Troy, MI 48084
Telephone: (313) 583-1525

b) Lawrence F. Portnoy (Designated Representative)
Price Waterhouse
Office of Government Services
1801 K Street, N.W.
Washington, D.C. 20006
Telephone: (202) 822-8572

2) Summary of Comments and Recommendations.

Taxpayers who incurred casualty losses of trade or business property prior to January 1, 1986 and who are in the process of replacing such property under the Involuntary Conversion provisions of Section 1033, Internal Revenue Code, have suffered a two-fold detriment caused by the enactment of the Tax Reform Act of 1986. First, they are required to pay taxes on recaptured depreciation and investment credit on the property lost by casualty and; second, under TRA 86 they must depreciate the replacement real property over a much longer life and they are not entitled to the investment credit on certain replacement equipment acquired after December 31, 1985.

In addition, taxpayers utilizing a small issue Industrial Development Bond to finance the replacement of property lost through a casualty can incur additional annual interest costs due to the enactment of TRA 86. Under TRA 86, financial institutions acquiring small issue Industrial Development Bonds after August 7, 1986 will not secure a tax deduction for interest expense allocable to the earning of tax exempt interest on bonds which they carry. Therefore, they will require a higher rate of return on such Industrial Development Bonds.

Recommendations to correcc this inequity in relation to a specific taxpayer, Cadillac Products, Inc. are:

(S.1350) --

Section 102(d) . . . . (38) the amendments made by Section 201 shall not apply to . . . .

"(I) Cadillac Products Inc. and its subsidiaries and affiliated company in relation to the replacement of the building and equipment totally destroyed by fire at Terre Haute, IN on December 28, 1985 with a total replacment project cost of approximately $2,200,000 for the building and $7,800,000 for the machinery and equipment and approximately $1,000,000 of machinery and equipment at Rogers City, MI replacing manufacturing capacity lost at Terre Haute, IN."

Section 109(b)(1) - Paragraph (3) of Section 902(f) of the Reform Act is amended --

. . . .

(D) By adding at the end thereof the following new paragraphs:

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"(W)Cadillac Products Inc. and its subsidiaries and affiliated company, plant and equipment replacement relating to the total loss by fire of the manufacturing plant at Terre Haute, IN on December 28, 1985."

Cadwalader, Wickersham & Taft

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D. C. Alexander
(202) 862-2336

July 20, 1987

Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Re: S.1350 - Amendments to Title VII
Nonconventional Fuels Credit

Dear Ms. Wilcox:

This letter is in response to the request of the Senate Finance Committee for comments on S.1350, the Technical Corrections Act of 1987. The purpose of this letter is to identify a technical problem relating to the interaction between the alternative minimum tax ("AMT") imposed under Title VII of the 1986 Act and the nonconventional fuels credit allowed under section 29 of the Internal Revenue Code and to propose a technical correction that would solve that problem.

The purpose of Congress in enacting the nonconventional fuels credit was to protect investments in nonconventional fuels projects against declines in the price of oil. See H. Rep. No. 817, 96th Cong., 2nd Sess. 139 (1980). The credit is in the nature of a price subsidy and is based on the quantity of nonconventional fuels produced and the degree to which oil prices have fallen below a statutory minimum.

Under Code section 55, as amended by the 1986 Act, the AMT is calculated as the excess of the tentative minimum tax over the regular tax. One of the objectives of the 1986 amendments to the AMT was to ensure that incentive tax credits such as the nonconventional fuels credit could not be accumulated in a single year to such an extent that they eliminate all tax liability for the year. Accordingly, Congress amended each of the Code sections that allows an incentive credit to prevent the use of incentive credits to reduce regular tax to an amount less than the tentative minimum tax. One of the fundamental assumptions underlying this change was that credits disallowed in one year could be carried forward to subsequent years in which the taxpayer's regular tax liability exceeds its AMT liability. This assumption was reflected in both the House and Senate versions of the Act and was described in the Statement of Managers as follows:

> Under the House bill, incentive tax credits generally are not allowed against the minimum tax. <u>Credits that do not benefit the taxpayer due to the minimum tax can be used as credit carryovers against the regular tax.</u> Corporations with net operating losses in two of the last three years before 1986 can use pre-1986 credits to offset 75 percent of minimum tax liability. . . .
>
> . . . .
>
> The Senate amendment is the same as the House bill, except that no credits can be used by any corporation to offset minimum tax liability.
>
> . . . .
>
> The Conference agreement generally follows the Senate amendment, except that as a transition rule, regular investment tax credits are permitted, in effect, to reduce minimum tax liability by 25 percent.

H.R. Rep. No. 841, 99th Cong., 2nd Sess. II-280 (1986) (emphasis added).

The plain meaning of the underscored language from the Statement of Managers is that Congress anticipated that an incentive credit that was disallowed solely because of the AMT would be available as a carryover in subsequent years. Notwithstanding the Conference Committee's anticipation of how the law would work, the effect of the applicable Code provisions, in the case of the nonconventional fuels credit, is <u>permanently</u> to disallow the credit if its use is limited by the AMT. <u>See</u> I.R.C. § 29(b)(5).

A permanent disallowance of the nonconventional fuels credit by application of the AMT provisions would have a unique effect on that credit. Because the credit is based on production, it can only be claimed after the project has come "on line" and production has commenced. Thus, the credit may not be available until long after the taxpayer's investment in a nonconventional fuels project has been made. In this respect, the nonconventional fuels credit differs from other incentive credits, which generally may be claimed in the taxable year when the taxpayer makes the expenditure that will qualify the taxpayer for a credit. For example, the targeted jobs credit is claimed in the year when qualified wages are paid. The research credit is claimed in the year when qualified research expenses are incurred. The investment credit is claimed when the taxpayer places new section 38 property into service. (Although property may be placed in service in a year later than the year in which it is paid for, deferral of the credit can be avoided by electing an investment credit for "qualified progress expenditures".)

For most incentive credits, the taxpayer will generally be in a position to determine in the year of expenditure whether the AMT rule would deprive the taxpayer of a meaningful credit. Since the nonconventional fuels credit is not claimed until after the investment has been made and production has come on line, it is virtually impossible for the taxpayer at the time of investment to determine whether the AMT will deprive the taxpayer of a meaningful credit.

There is no reason to believe that Congress wanted the 1986 Act to dilute the tax incentive for investment in nonconventional fuels. Certainly the Committee Reports failed to alert members that the nonconventional fuels credit would be eliminated if the fuels were sold in a year when AMT applied. Moreover, the contrary, recent Congressional statements of concern that our dependence on imported oil has returned to the levels that preceded the 1973 oil embargo indicate that the policy behind the nonconventional fuels credit is as valid as ever.

We believe that the Congressional purpose of allowing a meaningful nonconventional fuels credit and of allowing a carryover of credits limited by the AMT will be effectuated only if the 1986 Act is corrected. Allowing a minimum tax credit carryover for any nonconventional fuels credits disallowed by operation of the AMT would be the most acceptable manner of correcting the 1986 Act, since it would limit the carryover to the narrow situation in which the problem occurs. Specifically, we propose that section 53(d)(1)(A) of the Code be amended by deleting the period at the end thereof and adding the following:

> "increased to the extent of the credits not allowable against regular tax by reason of section 29(b)(5)."

If you have any questions concerning the merits or mechanics of our proposed technical correction, please call me or my colleague Bill Chip.

With best wishes,

Sincerely yours,

Donald C. Alexander

Cadwalader, Wickersham & Taft

1333 New Hampshire Ave., N.W.

Washington, D.C. 20036

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July 24, 1987

HAND DELIVER

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
Dirksen Senate Office Building
Washington, D.C. 20510

Subject: Technical Corrections Act of 1987 as it Relates to Passive Foreign Investment Companies

Dear Ms. Wilcox:

Pursuant to Finance Committee press release number G-3, dated June 19, 1987, five copies of comments are hereby submitted on the Technical Corrections Act of 1987 (the "Bill")[1] as it relates to the passive foreign investment company ("PFIC") provisions found in sections 1291 through 1296 of the Internal Revenue Code of 1986 ("Code").[2]

RECOMMENDATIONS

I. *Background*

The PFIC provisions were intended by Congress to remove the economic benefit of tax deferral and the ability to convert ordinary income to capital gain which

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1 S. 1350 and H.R. 2636, 100th Cong., 1st Sess. (June 10, 1987).

2 Unless otherwise specified, all section references are to the Code or the regulations thereunder.

in some instances could be obtained under prior law by U.S. investors who invested in foreign corporations owning assets (such as stock or securities) which produce passive income.[3] The committee reports indicate that the PFIC provisions were directed to passive income earned by foreign investment funds.[4] However, the PFIC provisions as enacted also could affect the trading, services, and manufacturing profits of many foreign corporations engaged in active business operations.[5] The Bill mitigates many of the difficult problems inherent in applying the PFIC provisions to active operating companies. However, we believe that a number of the remaining PFIC provisions are inappropriately harsh when applied to active operating companies and that a number of additional technical corrections are needed.

II. *DEFINITION OF PASSIVE FOREIGN INVESTMENT COMPANY*

A. *Income Test*

A technical correction should provide that a foreign corporation engaged in the active conduct of a trade or business will meet the income test of section 1291(a)(1) only if 75 percent or more of its *gross receipts* (rather than *gross income*) consists of passive income. Section 1296(a)(1), as enacted, results in the passive income earned by a foreign corporation engaged in active manufacturing or sales operations being given greater weight in the determination of its PFIC status than sales income since sales income is reduced by the cost of goods sold in determining gross income for tax purposes.[6]

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[3] H.R. Rep. No. 426, 99th Cong., 1st Sess. 408-09 (1985); S. Rep. No. 313, 99th Cong., 2d Sess. 393-94 (1986).

[4] *Id.*

[5] In this regard, we concur with the statement of Deputy Assistant Secretary (Tax Policy) of the Treasury O. Donaldson Chapoton that the PFIC definition currently encompasses too broad a category of companies. Statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Taxation and Debt Management, Committee on Finance, United States Senate at 9 (July 22, 1987).

[6] For example, a manufacturing company which sells goods for $200,000,000 where its cost of goods sold is also $200,000,000, has no gross income from the sale of goods. If the company derives $10,000 of passive income, it is technically a PFIC.

B. *Asset Test*

1. *Asset Test Applied to Net Assets at Fair Market Value.* A technical correction should provide that the asset test of section 1296(a)(2) applies to the *net* assets of the corporation (after taking into account liabilities) with all assets being taken into account at fair market value. Such provision would prevent the distortions which might otherwise occur where, as is often the case, a corporation incurs significant debt to acquire assets (whether active or passive). Valuation of assets on any basis other than fair market value (for instance, book value) would result in passive assets being given proportionately greater weight in the determination of PFIC status than non-passive assets.[7]

2. *Assets Producing Passive Income.* A technical correction should provide, for purposes of the asset test, that (i) an asset which produces both passive and non-passive income or receipts will be treated as producing passive income or receipts only to the extent of the ratio of the passive income or receipts produced by the asset to the total gross income or receipts produced by the asset over a time period, and (ii) an asset which does not produce any income will be treated as held for the production of passive income only if the principal purpose of holding such asset is the production of passive income.

C. *Definition of Passive Income*

1. *Section 904(d) Look-Through Rules.* A technical correction should explicitly provide that the look-through rules of section 904(d)(3) and (5) apply in determining whether dividends, interest, royalties, and rents received from a related person (within the meaning of section 954(d)(3)), and the assets giving rise to such income,

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7 For example, an active operating company might show, on its books, $50 million of active assets and $50 million of passive assets, and derive $15 million in income during a year. The passive assets would only result in a $4-5 million income stream. Much of the remaining $9-10 million in income is attributable not only to the $50 million in active assets on the books, but also to intangibles associated with active business operations (such as contracts, distribution networks, etc.) which may not be shown on the books.

constitute passive income or receipts or passive assets.[8] Such technical correction should provide that, in cases in which the look-through asset produces both passive and non-passive income or receipts, such asset should be treated as producing passive income or receipts only to the extent of the ratio of the passive income or receipts produced by the asset to the total gross income or receipts produced by the asset over a period of time. The PFIC rules should not apply to a corporation if it reinvests operating profits through a related corporation, rather than through a branch. Application of the section 904(d) look-through rules would ensure such a result, as was apparently intended by Congress.[9]

2. *Income Derived by Foreign Banks.* A technical correction should exclude from passive income the income derived in the active conduct of a banking, financing, or similar business by a foreign corporation doing business under a foreign country's banking or credit laws. The uncertainty created by requiring foreign banks not licensed to do business in the United States to await the exercise of regulatory authority to exempt their banking income from passive income potentially places such corporations which are owned directly or indirectly by U.S. persons at a competitive disadvantage vis-a-vis those owned by foreign persons.

3. *Exclusion of Effectively Connected Income.* A technical correction should define passive income to exclude income which is effectively connected with the conduct of a trade or business within the United States unless such income is exempt from taxation (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States. (*See* section 952(b)). Neither deferral of tax nor the ability to convert ordinary income to capital gain is available with respect to such income.

D. *25 Percent Owned Corporations*

1. *Scope of Application.* A technical correction should provide that the look-through rule of section 1296(c) applies only to the extent that the effect is to treat a

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8 This rule would not apply to assets and income eliminated under the section 1296(c) look-through rule, discussed below.

9 *See* Staff of the Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987* at 209 (Comm. Print 1987).

foreign corporation that is otherwise a PFIC (under the general rule of section 1296(a)) as a corporation which is not a PFIC, and does not apply to treat a corporation which is not a PFIC (under the general rule of section 1296(a)) as a corporation which is a PFIC. Section 1296(c) was intended to prevent holding companies formed to own active operating subsidiaries from being treated as PFICs. Under section 112(n)(17) of the Bill, a distribution from, and a disposition of stock of, a lower tier corporation which is a PFIC would be treated as a distribution to, or a disposition by, a United States person treated as owning stock in the PFIC under the attribution rules of section 1297(a), and thus would not escape application of the PFIC provisions if the suggested technical correction were made.

2. *Attribution of Ownership.* A technical correction should provide that, for purposes of determining whether a foreign corporation owns 25 percent (by value) of the stock of another corporation (but not for purposes of attributing income and assets),[10] both indirect and *constructive* ownership rules apply. *See, e.g.*, section 267(b), (c) and (f). Unless constructive, as well as indirect, ownership rules are applied, the section 1296(c) look-through rule would be extremely narrow.[11]

3. *Elimination of Stock and Debt.* A technical correction should provide that in attributing income and assets of 25 percent owned foreign corporations to an upper tier foreign corporation, the stock and debt, and dividends, interest and gain with respect thereto, held by one 25 percent owned foreign corporation in another 25 percent owned foreign corporation should be eliminated from the assets and income of the former corporation. This was the apparent intention of the provision.[12]

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[10] Application of constructive ownership for purposes of attributing income and assets would be administratively unwieldy, as almost all corporations in a group would be deemed to own almost all others in the group.

[11] For example, in the case of a foreign corporation 10 percent of the stock of which is held by an upper tier foreign corporation and 90 percent of the stock of which is held by the upper tier foreign corporation's U.S. parent, the look-through rule would not apply unless constructive ownership rules were made applicable.

[12] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 1026 (Comm. Print 1987) ("Bluebook").

E. *Time for Determination of PFIC Status*

A technical correction should clarify that stock of a foreign corporation will be treated as stock of a PFIC *only* if such foreign corporation was a PFIC for one or more post-1986 taxable years.

III. *NONQUALIFIED FUNDS*

A. *Foreign Tax Credits*

A technical correction to section 1291(a)(1)(C) should clarify that the entirety of the deferred tax amount constitutes a tax which may be offset by foreign tax credits. This appears to have been the intention.[13]

B. *Gain on Disposition*

1. *Gain Limited to Earnings and Profits.* A technical correction should provide that section 1291 applies to gain recognized on a disposition of PFIC stock only to the extent of the taxpayer's ratable share of the earnings and profits of the PFIC accumulated for the period the taxpayer held such stock. Section 1291(a)(2), as enacted, potentially applies the interest charge to gain attributable to appreciation unrealized at the corporate level, such as the appreciation of tangible and intangible assets, with respect to which the payment of U.S. tax has not been deferred.

2. *Pro Rata Share.* In determining the amount of gain on a disposition of PFIC stock subject to section 1291, a technical correction should provide that a taxpayer's pro rata share of the earnings and profits of the PFIC excludes the taxpayer's pro rata share of any earnings and profits which are attributable to (i) amounts previously included in gross income of the taxpayer under sections 551, 951(a), and 1293(a) (but only to the extent the inclusion of such amount did not result in an exclusion of any other amount from gross income under section 551(d), 959(a), or 1293(c)),[14] (ii) income which is effectively connected with the conduct of a trade or business in the

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[13] *See* section 1291(a)(4). *See also* Bluebook at 1027.

[14] The Bill includes a provision that would exclude such amounts from excess distributions. Bill section 112(n)(3).

United States unless exempt from tax (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States, (iii) income subject to an effective rate of tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11, (iv) income of the PFIC other than passive income, and (v) income earned for taxable years of the PFIC beginning before January 1, 1987.

Amounts included currently in gross income under section 551, 951(a), and 1293(c) and amounts effectively connected with a U.S. trade or business are not subject to deferral and should not be subject to PFIC treatment. Where there would be little or no U.S. tax owed because of the foreign tax credit under section 902 or 960, no interest element should apply. Gain attributable to active business operations also should not be subject to PFIC treatment since it is only the elimination of deferral on passive income which was within the stated intent of Congress. Similarly, gain attributable to pre-1987 tax years should not be subject to PFIC treatment.

C. *Total Excess Distribution*

1. *Incorporation of Dividend Concept.* A technical correction should limit the term "total excess distribution" to dividends paid out of earnings and profits. There is no precedent in either law or policy for subjecting to taxation a return of capital. Thus, taxation of such amounts cannot be deferred.

2. *Exclusions from Earnings and Profits.* For the reasons discussed in B.2 above, a technical correction should exclude from total excess distributions any earnings and profits attributable to amounts described in (i) through (v) of B.2 above (that is, previously taxed income, U.S. business income, income subject to a high rate of foreign tax, active income, and pre-1987 income).

D. *Allocation of Excess Distribution*

The amount of an excess distribution (or gain subject to section 1291) should be allocated to the taxable year (or years) in the taxpayer's holding period during which the earnings and profits giving rise to such excess distribution (or gain) were earned. This methodology would provide a better measure of the economic value of deferral and would ensure that amounts allocated to post-1986 years actually arose in such years.

E. *Mark-to-Market Election*

A technical correction should make the mark-to-market election of sections 1291(d)(2) and 1297(b)(1) expressly applicable to stock held indirectly, and should provide for a basis increase up the corporate chain with respect to indirectly held stock deemed disposed of under the election. As enacted, it is unclear whether the election also applies to second and lower tier foreign subsidiaries of a directly held foreign corporation. A basis increase up the corporate chain prevents double taxation on a disposition by the direct foreign corporation shareholder.

IV. *QUALIFIED ELECTING FUNDS*

A. *Exclusion of Effectively Connected Income*

A technical correction should provide that earnings and profits attributable to income which is effectively connected with the conduct of a trade or business in the United States are not included currently in the income of U.S. person PFIC shareholders unless such income is exempt from tax (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.[15] U.S. tax on such amounts cannot be deferred in any event. Inclusion of earnings and profits attributable to such amounts potentially results on a current basis in a triple U.S. tax, *i.e.*, corporate tax at graduated rates, branch profits tax, and shareholder level tax.

B. *Investments in United States Property*

A technical correction to section 951(f) should be made to prevent a double inclusion of amounts which would be taxable as both an increase in earnings invested in the United States property and earnings and profits of a qualified electing fund.

V. *Rules for Allocation of Interest, etc., to Foreign Source Income*

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[15] In making this change, an ordering rule similar to that in section 959(c) would be needed so as to determine the extent to which subsequent distributions are made from previously taxed income.

Ms. Laura Wilcox
Page 9

July 24, 1987

A technical correction should provide that, for purposes of determining the basis of stock of a "nonaffiliated" 10 percent owned corporation under section 864(e), proper adjustments should be made to the earnings and profits of any corporation to take into account any earnings and profits included in gross income under subpart F, the PFIC provisions, or any other provision and reflected in the adjusted basis of *any property*. Although section 112(g)(1) of the Bill makes a similar correction, such provision can be interpreted to apply only to the extent earnings and profits currently included in a U.S. person's gross income increase the basis of the stock of the foreign corporation with respect to which such inclusion is made. However, such a result is too narrow to prevent double counting since current inclusions of the earnings and profits of a lower tier foreign corporation under sections 951 and 1293 increase, not the basis of the stock of that foreign corporation, but the basis of the property on account of which the taxpayer is treated as owning the stock of such corporation. Sections 1293(d)(1) & 961(a).

* * * * *

We appreciate the opportunity to comment on the Bill. If you have any questions or comments, please contact me or Nancy H. Kaufman at (202) 862-2200.

Respectfully submitted,

Kenneth Klein

Kenneth Klein

cc: Ms. Mary McAuliffe (five copies)

Designated Representative:
Kenneth Klein
Cadwalader, Wickersham & Taft
1333 New Hampshire Ave., N.W.
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In summary of the comments and recommendations attached hereto, we recommend a number of technical changes to the passive foreign investment company ("PFIC") and related provisions. Many of the changes are designed to mitigate the harsher aspects of the PFIC provisions as applied to active operating companies, such as: applying the gross income test for PFIC status to *gross receipts* of corporations actively engaged in business; measuring a corporation's passive assets with reference to the *net* value of *all* of the assets of the corporation taken into account at fair market value; applying the section 904(d) look-through rules to determine the passive status of assets of, and income from, related persons; applying the section 1291(c) look-through rule only to the extent the effect is to treat a corporation that is otherwise a PFIC as not a PFIC; and making the interest charge inapplicable to amounts previously included in gross income under other Code provisions, income effectively connected with a U.S. business, income subject to high foreign tax, income other than passive income, and income earned for taxable years beginning before January 1, 1987. A number of other recommendations address general problems under the PFIC provisions, such as: clarifying that stock of a foreign corporation will be treated as stock of a PFIC *only* if the foreign corporation was a PFIC for one or more post-1986 taxable years, excluding from passive income the banking income of foreign banks not licensed to do business in the United States; defining the term "total excess distribution" with reference to earnings and profits; allocating excess distributions (or gain on disposition) to the taxable year (or years) during which the earnings and profits were earned; and broadening section 951(f) to prevent a double inclusion of amounts which would be taxable as both an increase in earnings invested in United States property and earnings and profits of a qualified electing fund.

CALIFORNIA FEDERAL

William L. Callender
President and
Chief Executive Officer

July 22, 1987

The Honorable Lloyd Bentsen
United States Senate
Committee on Finance
Dirksen Office Building 205
Washington, D.C. 20510

Re: Technical Corrections Act of 1987

Dear Senator Bentsen:

Section 503 of the Tax Reform Act of 1986 extended the "at risk" loss limitation rules to deductions resulting from the holding of real property acquired by the use of nonrecourse financing. This change was apparently enacted primarily to prevent the perceived abuse of inflated depreciation deductions arising from overvalued purchase prices. The expanded "at risk" limitations, however, created an exception for certain nonrecourse loans secured by real property where the borrowing is from "any person who is actively and regularly engaged in the business of lending money" ("qualified person"), such as California Federal Savings and Loan Association.

Notwithstanding the general rule that a borrower is considered at risk with respect to nonrecourse real estate financing from a qualified person, the 1986 TRA disqualifies the transaction where the qualified person is related to the borrower or is (or is related to) the seller of the real property. However, Congress apparently further recognized that the potential for tax abuse is negated when the financing is on substantially the same terms as other loans made by lenders regularly engaged in the business of real estate lending. Accordingly, the 1986 TRA provides that qualified nonrecourse real estate financing to a related person will be treated as at risk "if the financing from the related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons". This "commercially reasonable" exception does not, however, apply where the qualified person is also the seller, or is related to the seller, of the real property. Therefore, the 1986 TRA at risk limitations would apply to California Federal's nonrecourse financing of sales of its own real property, including property acquired by foreclosure or similar proceeding, even if the loan is on a commercially reasonable basis.

Savings and loans are substantially limited by law, regulation and public policy considerations to the business of real estate lending. Unfortunately, however, the 1986 TRA is now operating as a barrier to the long-standing and highly-regulated principal business of this industry.

Historically, savings and loans have provided financing on most sales of their own real property. A significant result of the expanded at risk rules will be to substantially aggravate the already existing difficulties and adversities involving the disposition of foreclosed properties by requiring potential purchasers to arrange financing from other lenders unfamiliar with the property. In many, if not most, of such situations, alternative financing will not be readily available because of the distressed nature of the underlying property. These new rules will be particularly prejudicial to savings and loans, such as California Federal, operating in the 10 states where state law prohibits lenders from making recourse loans with respect to such sales.

Certain concerns have been raised that an exception for seller financing by savings and loans would continue the perceived tax abuse from overvalued purchase prices. This is simply not the case. The 1986 TRA provisions that curtail accelerated depreciation methods and extend the useful life of newly-acquired real property have eliminat~~ed potential~~ tax benefits to purchasers from inflated purchase prices. In fact, these changes result in a purchaser tax penalty from inflating the purchase price as evidenced by the attached study prepared by Mr. Gregory Ballentine of Peat, Marwick, Main & Co. In addition, the enactment of the passive loss limitation rules provide a significant barrier to the deductibility of any losses from holding real estate notwithstanding the amount at risk by an individual investor.

The issue of qualified person seller financing is of major importance to the savings & loan industry and, on behalf of California Federal, I respectfully request that this issue be favorably addressed in the Technical Corrections legislation or otherwise resolved at the earliest possible time.

Sincerely,

THE TAX EFFECTS ON A BUYER OF INFLATING BASIS IN REAL ESTATE ACQUISITIONS

J. Gregory Ballentine

Peat, Marwick, Main & Co.

Two previous reports have examined the combined tax effect on buyers and sellers of real property arising from the inflation of basis. Those reports demonstrated that the changes to depreciation and capital gains tax rates enacted in the Tax Reform Act of 1986 have largely eliminated any net tax benefits from inflating basis. This short report concentrates only on the tax effect on the buyer from inflated basis.

The basic transaction is a simplified, extreme example of inflating basis. Property is purchased for $X paid after 10 years. Thus, the purchase involves an implicit loan which carries a zero interest rate. Such an extreme, simple example is used to highlight the issue. Seller financing and other tax rules would prevent the extreme overvaluation that results from this example. Including such tax rules in the example would make the conclusion even stronger, while complicating the analysis.

By using a zero interest rate implicit loan, the basis of the asset will be stated as \$X. If an explicit loan at the interest rate i were used instead, the basis of the asset would be $\frac{X}{(1+i)^{10}}$.

Thus basis is inflated by

$$X - \frac{X}{(1+i)^{10}} .$$

There are two tax effects on the buyer from this. First, the buyer receives additional depreciation deductions. Second, the buyer loses the interest deductions that would have been available if an explicit loan were used.

The present value of \$1 written off straight-line over 31.5 years at a 10% discount rate is 28.6 cents. Thus, assuming the buyer is in the 28% tax bracket, the additional depreciation benefits for the buyer are

$$(.28)\ (.286)\ \left(X - \frac{X}{(1+i)^{10}} \right)$$

or

$$(.28)\ (.286)\ \left(1 - \frac{1}{(1+i)^{10}} \right) X .$$

With i=.1, this simplifies to

$$.0492\ X.$$

Thus, the buyer gets 4.9 cents present value additional tax benefits per dollar of X.

The buyer loses interest deductions by inflating basis with a zero interest rate implicit loan. The present value of the loss is equal to the present value of the interest on the loan times the buyer's tax rate (28%).

The present value of the interest on a loan of $1 for ten years, discounted at 10% is .9091. The present value of the interest on the entire implicit loan--the entire loan is equal to $(X/1.1^{10})$--is

$$X \ \frac{1}{(1.1)^{10}} \ .9091$$

which equals X .3505.

The tax loss therefore is

(.28)(.3505)X

or .0981 X.

Thus, the buyer <u>loses</u>, in present value terms, 4.89 cents in taxes (.0981 - .0492) for every dollar of X. For every dollar of inflated basis, the buyer loses 7.96 cents. Not only is the combined tax effect on the buyer and seller a tax loss (as explained in previous reports), but the effect on the buyer alone is a tax loss. Clearly, no buyer will agree to inflating basis in order to obtain a tax benefit.

Campbellsville College
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July 3, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

The technical corrections bill covering details of the Tax Reform Act is pending in the Senate. I have these comments.

It is my belief and opinion that the bill should be amended to clarify that charitable gift annuities are not subject to IRC Sec. 501(m). This section could be interpreted in such a way as to treat charitable gift annuities as commercial-type insurance. They are not and should not be treated so. Here are my reasons.

1. Gift annuities are used by donors to Campbellsville College and other charitable organizations because they are interested in our institution. They do not see them as a financial investment, but as a deferred gift to Campbellsville College.

2. In no way do gift annuities compete with commercial annuities. They are not commercial-type insurance.

3. If the law is not clarified, it is my opinion that an important source of funds to Campbellsville College would dry up.

4. Gift annuities are used by donors who are in a position to make small gifts, as small as $500 or $1,000, on a deferred basis to Campbellsville College. They do this in much the same way as larger donors use the charitable remainder annuity trust. They are somewhat equivalent and yet the charitable remainder annuity trust is not affected by IRC Sec. 501(m).

5. Historically, charitable gift annuities have never been treated as an unrelated trade or business. In fact, Congress added Tax Code Section 514(c)(5) specifically to exclude charitable gift annuities as an unrelated business activity. Sec. 514(c)(5) was not amended by the Tax Reform Act.

Again, I express to you my sincere desire and wish for you to amend the Technical Corrections Act of 1987 to clarify that charitable gift annuities are not subject to IRC Sec. 501(m). Thank you for your attention.

Sincerely,

Kenneth H. Pope

Kenneth H. Pope, Ph.D., CFRE, CFP
Advancement Vice President

KHP:pjd

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WRITER'S DIRECT DIAL NUMBER
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July 21, 1987

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

Dear Senator Bentsen:

I am writing to register opposition to the approach toward tax treaties in the Technical Corrections Act of 1987, both in general and in specific regard to the tax on "excess interest" imposed under the new "branch level" tax regime enacted by the Tax Reform Act of 1986. That approach deviates from traditional U.S. policy in international tax matters and is likely to result in harm to U.S. business and other interests abroad.

Section 112(y) of the Act, entitled "Coordination with Treaties," contains in subparagraph (2)(C) a sweeping clause to the effect that any and all amendments made by the Tax Reform Act shall apply notwithstanding any treaty obligation of the United States, except as otherwise provided in the Reform Act or in paragraph (3) of that same section. Paragraph (3) lists eight specific provisions of the Reform Act which are not to apply to the extent their application would be contrary to U.S. treaty obligations.

A Joint Committee Print which describes the Technical Corrections Act briefly reviews the statutory scheme described above and then sets forth the understanding of the authors of the Print that there are no other "cases . . . where a harmonious reading of the Act and U.S. treaties is not possible." On page 235 of the Print, the following statement appears:

> Other Act provisions that are understood to be fully consistent with U.S. treaty obligations include the Act's dual residence company provisions (Act sec. 1249) and the Act's branch level interest tax provisions (Act sec. 1241). In the latter case, the obligation for U.S. tax on a foreign corporation's "excess interest" arises from the foreign corporation's deduction of interest on amounts payable to third-party lenders. The mere collection of this tax at one time (i.e., the end of the corporation's taxable year) from the foreign corporate payor of interest, rather than requiring the payor to withhold

> U.S. tax on interest payments made throughout its taxable year, does not make the tax discriminatory.

The Print goes on, however, to state:

> If, in any of the cases described above where conflicts are understood not to exist, any treaty is somehow read to bar operation of the Act, the Act is to be effective notwithstanding the treaty.
>
> Notwithstanding Congress' intent that the Act and income tax treaties be construed harmoniously to the extent possible, conflicts other than those addressed in this bill or in the Act ultimately may be found to exist. Therefore, the bill provides that except as otherwise provided by the bill or the Act, the provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986). If any such now-unknown conflict is ultimately found, it is expected that full legislative consideration of that conflict will take place to determine whether application of the general later-in-time rule is appropriate.

Finally, the Print states: "In addition, this technical corrections bill is understood not to conflict with any treaty. Again, should a conflict ultimately appear, the bill's provisions are to take effect."

In short, the intention is to override treaty obligations with respect to known treaty/Code conflicts except in certain specific cases; to explain the "harmonious" relationship between treaties and statutory law in other instances but, to be on the safe side, to override treaties there too; and to impose statutory law in the case of treaty/Code conflicts not yet identified or known to exist.

There is no doubt, under the Constitution, that Congress has the power to override, and thus unilaterally abrogate, international agreements of the United States. However, the fact that this power exists does not justify its exercise in any particular case. There are some obvious implications to repudiating formal government-to-government commitments; such repudiations are clearly more than mere "technical corrections" to existing legislation.

The proposed treatment of the branch level tax on excess interest offers a clear illustration of the seriousness of the legislative action that has been proposed. That tax operates, in general, as follows: The amount of the deduction for interest expense allowable to a foreign corporation engaged in a U.S. trade or business is the product of a formula under Treasury Regulation § 1.882-5. The formula can and often does yield a deductible amount that is different from (greater or less than) the amount of interest actually paid and booked by the U.S. business. The tax on "excess interest" is, in effect, a tax on the amount by which the deduction, in a given case, exceeds the amount of the payment. As a technical matter, under Code section 884(f)(1)(B), the amount of the excess is treated as if it were interest paid to the foreign corporation by a wholly-owned domestic corporation. This approach implicates the "taxability" rules of the Code and U.S. treaties; the excess interest may or may not be taxable depending on whether it is considered a bank deposit, interest on portfolio debt, or interest qualifying for a reduced rate of tax or exemption under a U.S. tax treaty. (The rules for "tracing" the excess interest to these various categories of debt are presently unclear; but presumably the issues presented here can be resolved through Treasury regulations in due course.)

The tax on "excess interest" raises several issues under U.S. tax and other treaties. Because section 884(f)(1)(B) is a fiction -- there is only one corporate entity in question, not two -- the tax arguably places a burden on a foreign corporation that a comparable U.S. corporation is not required to bear. On this view, the tax is discriminatory. The Joint Committee Print argues that the burden on the foreign corporation is no greater than the combined burden on a U.S. corporation and a foreign lender. This argument appears to be a dubious basis for a finding of nondiscrimination under international standards, but that is beside the point. We will never know whether the Technical Corrections Act conflicts with treaty nondiscrimination guarantees if the Act overrides all of those guarantees.

It is also arguable that "excess interest" does not have a U.S. source under treaties corresponding to the U.S. Model Income Tax Convention. The discussion at page 1042 in the General Explanation of the Tax Reform Act of 1986 is apparently to the contrary, but the point has never been adjudicated. What authority and commentary does exist suggests that interest must be linked to a U.S. business in some way other than deductibility in order to be sourced in the United States. Again, the question whether the General Explanation is correct here is less important than the apparent intention to enforce the staff's view through abrogating U.S. treaty commitments if the General Explanation should be wrong.

The Tax Reform Act of 1986 overrode treaties in numerous places, on a much more widespread basis than prior legislation. In many instances, however, these overrides were in the name of tax policy concerns either having some urgency or, at least, having relevance principally to U.S. persons (whom U.S. tax treaties are not generally intended to benefit). Thus, the overrides with respect to the new foreign tax credit rules are at least understandable. Similarly, the overrides in the case of the branch level tax, which prior to the Technical Corrections Act were limited to cases of treaty shopping, are also understandable. Congress evidently decided that treaty shopping is a pressing concern, and that the time required to renegotiate the U.S. treaty network to prohibit treaty shopping is simply too long to tolerate. U.S. treaty partners doubtless did not appreciate the unilateral repudiation of U.S. treaty commitments in the 1986 legislation, but they would be hard pressed to defend treaty shopping in general or, at least, to fail to appreciate the reasons for the Congressional action.

The Technical Corrections Act override for the tax on excess interest is not, however, limited to treaty shopping nor is it easily comprehensible. It would apply to all taxpayers who are not treaty shoppers and who operate in the United States in branch form (principally, but not solely, banks, which are the entities most affected by Treasury Regulation § 1.882-5). Many of these entities are publicly owned in their home countries and have their principal offices in those countries. They are not tax evaders. In general, their home countries impose taxes which are at least the equal of those in the United States. Moreover, the tax on excess interest would be the only piece of the branch level tax regime that would override treaty commitments in cases other than treaty shopping. Thus, if the Technical Corrections Act as it stands is enacted, the Code will not prohibit treaty shopping at all (will defer to treaties completely) in the case of U.S. subsidiaries; it will apply all aspects of the branch level tax regime with respect to treaty shoppers despite treaties; and it will apply the tax on excess interest to non-treaty shoppers despite treaties. The policy rationale for this patchwork scheme is difficult to discern.

Of course, it is not generally in the interests of the United States to override international agreements. Such overrides hardly comport with our professed allegiance to the rule of law. Not only do such actions have a tendency to inhibit the obtaining of new agreements in the future; they also undermine the word of the United States as expressed in international arenas more generally. Nor are any of these effects necessarily confined to the area of taxation, just because the abrogation is so confined.

But especially in the area of taxation, where the potential for counter-actions against U.S. interests is ever present, it makes little sense for the United States to disregard agreements that were struck in order to benefit the United States and its citizens and residents. Particularly in the area of discrimination, the United States has worked hard for many years to secure commitments from other countries, and one of the principal tools in this effort has been the nondiscrimination clause commonly found in tax and investment treaties. It is unwise for the United States to override such clauses.

A great deal of recent U.S. tax policy is driven by an obvious need for revenue. Whether the current budget situation justifies a disregard for long-standing, internationally shared principles of international taxation is, however, doubtful. In the case of the tax on "excess interest" such a disregard is peculiarly misplaced, since foreign banks can avoid additional tax costs by restructuring so as to fund U.S. operations from the United States. This may involve other, non-tax costs, but it is possible. If it is done, imposition of the tax on excess interest despite treaties will not produce additional revenues, yet the harm to U.S. stature in international tax matters will be no less.

Although most of this letter has focused upon the tax on "excess interest," similar observations could be made with respect to other Technical Corrections Act provisions relating to treaties, and especially other overrides of the nondiscrimination clause. The core issue here is not any particular statutory provision but a matter of general principle: Abrogations of treaty commitments are serious business. They should not be adopted simply because, at a given moment, Congress believes a particular tax policy is preferable to the one it followed in the past. They should require compelling justification. There is no such justification here.

Sincerely,

H. David Rosenbloom

Written Testimony Submitted to the Senate Finance Committee

by

Charles L. Sykes

Assistant Executive Director of CARE

and

Co-Director of the Coalition for Food Aid Policy and Programs

The Water Resources Act of 1986 authorizes the Customs Service to assess a harbor maintenance fee of 0.04 percent on the value of commercial cargo loaded or unloaded from a commercial vessel. On June 29, 1987 the U.S. Customs, Department of Treasury's User Fee Task Force rejected an appeal by the American Friends Service Committee (exchange of letters attached) to exempt charitable and relief cargo from payment of the fee, citing Congress as the source for non-exemption.

The many U.S. charitable and private voluntary organizations, providing essential food, supplies and equipment for relief and development purposes to many of the poorest countries, are now being billed by the Customs Service in the same manner as commercial cargo. If it were not the intent of Congress to apply the harbor maintenance fee against the charitable cargoes of registered 501(c)3 organizations, we request the Committee to make a technical correction providing for such exemption.

AMERICAN FRIENDS SERVICE COMMITTEE

1501 Cherry Street, Philadelphia, Pennsylvania 19102

Area Code: 215-241-7000
Cable: AFSERCO PHA TWX 710 670 1617

May 26, 1987

Ms. Jean F. Maguire, Director
User Fee Task Force
Regulations Control Branch
Customs Service Headquarters
Room 2146
1301 Constitution Avenue, NW
Washington, DC 20229

Dear Ms. Maguire:

According to the Federal Register of March 30, 1987, the new Customs Service harbor maintenance fee is applicable to "commercial cargo".

The American Friends Service Committee is a non-profit agency of the religious Society of Friends (Quakers). We are engaged in work of relief and reconciliation to relieve human suffering in many countries. Our shipments of donated clothing, medical and other relief supplies are distributed free of charge to needy people under the supervision of our representatives. They are not "commercial" in any sense of that word.

We are registered with the U.S. Agency for International Development, which, in support of our programs, reimburses to us the cost of ocean freight on our relief shipments.

We, therefore, do not believe that we should be subject to the new harbor maintenance fee and would appreciate confirmation from you (addressed to the attention of the undersigned) that we are exempt from this fee.

Thanking you for your cooperation,

Sincerely yours,

A. W. Patterson
Director of
Purchasing and Shipping

AWP/dt

JUL 2 1987

DEPARTMENT OF THE TREASURY

U.S. CUSTOMS SERVICE

WASHINGTON, D.C. 20229

JUN 29 1987

FIS-04-08-UFTF RAS

Mr. H. W. Patterson
Director of Purchasing and Shipping
American Friends Service Committee
1501 Cherry Street
Philadelphia, Pennsylvania 19102-1479

Dear Mr. Patterson:

I appreciate the concern you expressed in your letter of May 26, 1987, and I do understand your position.

The Harbor Maintenance Fee (HMF) is, however, imposed for port use regardless of the nature of specific cargo, except for certain exemptions. The operation you describe is, unfortunately, not one of those exempted by Congress. There is no special exemption for charitable cargo. Funds collected by Customs are deposited in a "Harbor Maintenance Trust Fund to be used to contribute up to 40 percent of the... operation and maintenance of ports and harbors in the U.S." Formerly, these operations were financed from general revenues.

Please contact me if you need additional information.

Sincerely,

Jean F. Maguire

Jean F. Maguire
Director
User Fee Task Force

CARLTON AND JOHNSON
PUBLIC ACCOUNTANTS

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MEMBER, AMERICAN INSTITUTE
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MEMBER, NATIONAL SOCIETY
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POST OFFICE BOX 1800
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TELEPHONE (603) 356-5488

July 7, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Re: Technical Corrections Bill of 1987 - H.R. 2636
§10b(g) - 5 Year Holding Period As It Relates
to TRA §633(d) (6) Definition and Special Rules -
For a Qualified Group.

Dear Ms. Wilcox:

Enclosed please find my letter to Mr. Leonard, Chief Counsel of the Ways and Means Committee concerning the 5 year holding period as proposed under the Technical Corrections Act.

I can see no logic for the 5 year requirement and as I comment in Mr. Leonard's letter, I believe that the 5 year holding period is an unreasonable test that will truly frustrate congressional intent in allowing small corporations to liquidate during the transition period.

I would be pleased to discuss this with you.

Respectfully submitted,

ROBERT L. JOHNSON
CERTIFIED PUBLIC ACCOUNTANT

RLJ:djh
Encl.

cc: Mary McAwliffe
Minority Chief of Staff
United State Senate
Committee on Finance
Room SD-G08
Washington, D.C. 20510

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June 18, 1987

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Technical Corrections Bill of 1987 - H.R. 2636 §10b(g) - 5 Year Holding Period As It Relates to a TRA §633(d)(6) Definition and Special Rules - For a Qualified Group.

Dear Mr. Leonard:

As I am sure you are aware of, Technical Corrections is making what I believe to be a substantial change in the original Statute enacted under the Transition Rules by introducing a 5 year holding period as noted above.

I am sure from my experience, as well as other practitioners, that deals have been made in which the 5 year holding period has not been considered because it is not in the original Statute. I am puzzled by the restriction in any event. It seems to me that if the intent of Congress were to provide a true opportunity for the small corporation to liquidate during a transition period, the further complication of a 5 year holding period may neutralize that intent.

I believe that the 5 year holding period should be eliminated from the Technical Corrections Act. The 5 year restriction is an unreasonable test that will be difficult to enforce and in my judgment truly frustrate congressional intent.

I would be pleased to discuss this with you.

Respectfully submitted,

Robert L. Johnson

ROBERT L. JOHNSON
CERTIFIED PUBLIC ACCOUNTANT

RLJ:djh

Carnegie Mellon

The Campaign for Carnegie Mellon
Office of Estate Planning
Carnegie Mellon University
5000 Forbes Avenue
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412-268-2017

June 29, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance
S. D. 205
Washington, DC 20515

To Whom It May Concern:

Re: IRC Section 501(m) and Charitable Gift Annuities

As Director of Estate Planning at Carnegie Mellon University, I am responsible for our planned deferred giving program. An extremely attractive and important component of our program is the Charitable Gift Annuity. The Charitable Gift Annuity appeals particularly to the donor who wants to make a major charitable gift of, for example, $5,000 to $50,000, but financially and personally needs to retain an annual life income or annuity from his or her gift. Our Gift Annuities provide a key source of funding to Carnegie Mellon, which has become all the more important in the face of cutbacks in federal and state aid.

I feel strongly that the taxation of Charitable Gift Annuities under Section 501(m) of the Internal Revenue Code enacted by the Tax Reform Act of 1986 would be extremely detrimental to our long standing gift annuity program, as well as to the programs of other charitable organizations.

Charitable Gift annuities require a clear donative intent as the rate of annuity payout is not competitive with annuities paid by commercial type insurance.

On behalf of Carnegie Mellon University, and as a long time sponsor of the Committee on Gift Annuities, I respectfully request that you and your fellow committee members adopt a specific provision that Charitable Gift annuities are exempt from IRC Section 501(m). Thank you in advance for your support.

Very sincerely,

Gordon Gordon

Gordon Gordon
Director of Estate Planning

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WRITER'S DIRECT DIAL NUMBER

July 13, 1987

Hon. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: $2,000,000 Grandchild's Exemption from Generation-Skipping Tax -- Technical Corrections Act

Dear Sir:

We are writing this letter to inform you of concerns that we have relating to the provisions of the Technical Corrections Act dealing with the $2,000,000 exemption from generation-skipping taxes for transfers "to a grandchild". Section 114(g)(3)(B) of the proposed Technical Corrections Act provides that a transfer in trust will be treated as a transfer to a grandchild only if: (1) no portion of the corpus or income of the trust may be distributed to any person other than the grandchild during the life of the grandchild; (2) the assets of the trust will be includable in the gross estate of the grandchild if the grandchild dies before the trust terminates; and (3) all of the income of the trust for the period after the grandchild has attained age 21 will be distributed to the grandchild not less frequently than annually.

Our concerns relate to the third requirement. For the reasons set forth in the body of this letter, we recommend that the third requirement be deleted. If the Committee concludes deletion is impossible, we recommend that the age requirement be increased above 21. Finally, if the third requirement is included, we recommend that transfers made to any trust before the effective date of the Technical Corrections Act qualify for the grandchild exemption if the trust meets only the first two requirements.

The Third Requirement Is an Unnecessary Addition. The first two requirements were generally expected by practitioners and simply repeat the requirements that were necessary to obtain the $250,000 exclusion for transfers to grandchildren under the previous generation-skipping tax law. The third requirement, which requires income to be distributed at least as frequently as annually to the grandchild after the grandchild reaches age 21, is a new concept and was unexpected.

Unlike the first two requirements, the mandatory distribution of income is not necessary to protect the tax base of the Government. The first two requirements protect the Government from loss of revenue by insuring that the property in such a trust will be included in the grandchild's estate. Obviously, if property could be distributed to someone other than the grandchild from the grandchild's trust, any property so distributed would escape taxation in the grandchild's estate. The second requirement insures that even if the grandchild should die before the trust terminates, the property remaining in the trust will nonetheless be taxed in the grandchild's estate. Thus, the third requirement is not necessary in any way to protect estate and gift tax revenues. The first two requirements are sufficient to protect the federal fisc.

Neither are income tax revenues protected by the third requirement. Given the compression of income tax rates, no significant revenue would be lost from any accumulation of income in the trust. Further, since any accumulations of income after age 21 would be subject to the throwback rules in any event, no revenue of the federal government is protected by the third requirement.

When our office spoke with Mel Thomas of the Joint Committee on Taxation regarding the reasons for this third requirement, he indicated that the requirement was a matter of policy, designed to insure that the grandchild would have a "meaningful interest" in the trust. He indicated that the Joint Committee looked at Section 2056 of the Internal Revenue Code and Section 2503(c) in order to create the requirements for this "meaningful interest". It is our understanding that the Joint Committee combined the requirements of those two sections to generally require mandatory income distributions, but only after a grandchild reaches age 21.

It was stated by Mr. Thomas that Section 2056 contains the requirement that income must be distributed from a marital trust at least annually in order for transfers to the trust to qualify for the marital deduction. It is important to acknowledge, however, that several types of marital trusts qualify for the deduction. While a qualified terminable interest property trust or a general power of appointment marital trust must include a mandatory income payout provision, an "estate trust," which does not require current distributions of income, will also qualify for the marital deduction under Section 2056. Therefore, Section 2056 does not stand for the proposition that in order for an interest in trust to be meaningful, the trust must include a mandatory income payment provision.

The requirement that the property be included in the grandchild's estate if the grandchild dies prior to the termination of the trust, however, does give the grandchild a "meaningful interest" in the trust. Generally, inclusion in the estate is achieved either through a provision requiring the trust to be ultimately distributed to the grandchild's estate or a provision granting the grandchild a general power of appointment giving the grandchild the right to appoint the property at the grandchild's death to the grandchild's estate, the creditors of the grandchild's estate or the grandchild's creditors. Certainly, these provisions give the grandchild a meaningful interest. The grandchild can borrow against the property by obligating himself or herself to appoint the trust property to creditors or to the grandchild's estate at the grandchild's death, and the grandchild may direct the ultimate disposition of the trust.

Policy Considerations Behind the Age Requirement. While we believe mandatory payment of all income from a grandchild exemption trust should not be required, if it is required, we believe as a matter of policy that it is not advisable for a grandchild to begin receiving all of the income of the trust at age 21. Obviously, the income from a trust that has $2,000,000 (and possibly considerably more as a result of appreciation) will be quite substantial.

While age 21 is frequently used as a watershed age due to its long-standing association in many states with the age of majority, if the reasons behind the mandatory income payout after age 21 are to insure that the grandchild receives a "meaningful interest," it should be carefully considered as to whether age 21 is an appropriate age at which the income should be required to be paid out, or whether in fact the grandchild's interest might be more meaningful were that mandatory income payout, if one exists, to be started at a later age.

It is our understanding that age 21 was selected by the Joint Committee because that is the age at which a trust for a minor must terminate in order to qualify for the annual exclusion from gift taxes pursuant to Section 2503(c). A 2503(c) trust is generally created by donors to provide for a child's education and is therefore substantially smaller than a completely funded ($2,000,000) grandchild exemption trust would be. Accordingly, the requirement that trust property be distributed when a beneficiary reaches age 21 from a 2503(c) trust (by which time the beneficiary is usually near the completion of college and the assets of the trust have been substantially depleted) is not as critical as it would be in a fully funded grandchild exemption trust.

Nonetheless, it should be noted that many donors have chosen not to utilize 2503(c) trusts in recent years as a result of the mandatory payout at age 21. Our experience with clients has been that they are unwilling for a trust for a child to terminate so early, not because they desire to keep the beneficial enjoyment of the property away from the child, but because they believe the child will be better able to enjoy the property for a longer period of time if the termination of the trust occurs when the child is more mature.

The Third Requirement Is a Substantive Change Which Is Not Appropriate in a Technical Corrections Act and For Which Relief Should Be Granted From Its Retroactive Effect. Even if it is ultimately decided that for policy reasons the mandatory income payout after age 21 (or whatever age is finally determined) should be made a requirement for qualification for the grandchild exemption, the Technical Corrections Act is not the appropriate vehicle by which this change should be made. This is a substantive change which should not masquerade as a technical correction.

If this requirement is included in the Technical Corrections Act, this provision, as currently proposed, has a retroactive effect for which relief should be granted. No transfers to trusts not containing this mandatory income payout should be disqualified from using the grandchild exemption if the transfer was irrevocable before the Technical Corrections Act date of enactment.

While the Tax Reform Act of 1986 did not include provisions relating to what types of trusts would qualify for the grandchild exemption, the Conference Agreement relating to the Tax Reform Act implicitly authorized transfers to a trust. A special election is permitted to allow qualification of a pre October 22, 1986 transfer to a trust in cases where the trust estate would pass to the grandchild's heirs (and not the grandchild's estate) at the grandchild's death.

The clear implication of this special election is that for post October 22, 1986 transfers, so long as the grandchild's interest in a trust is vested (i.e., payable to the grandchild's estate or pursuant to a general power of appointment at the grandchild's death), it would qualify as a direct skip for the grandchild exemption. Non-vested interests would be permissible only if they were created prior to October 22, 1986 and an election were made to treat them in this manner (which would result in an estate tax in the grandchild's estate at the grandchild's death).

The ability to use trusts so long as the trust property would be includable in the grandchild's estate is in accord with the prior generation-skipping tax provisions. That is, to qualify for the $250,000 exclusion from taxable distributions or taxable terminations for transfers to grandchildren under the prior generation-skipping tax law, the statute stated that the exclusion existed for transfers "to a grandchild". That is the same language that was used in the Tax Reform Act of 1986 relating to the $2,000,000 exemption. The regulations under the previous Section 2613 clarified that with respect to gifts made to trusts, the exclusion for transfers "to a grandchild" would be available only if the property would be includable in all events in the grandchild's Federal gross estate if the grandchild died at any time after the generation-skipping transfer. See Reg. §26.2613-4(a).

Individuals, by wills, which are now effective as a result of the death of the individual between the date of the Tax Reform Act of 1986 and the Technical Corrections Act, have created trusts which created a vested interest in the grandchild and were therefore believed to qualify for the $2,000,000 exemption. Other individuals, for a variety of personal, health, and financial reasons, have made transfers which were irrevocable prior to the date of the introduction of the Technical Corrections Act into Congress. It would be blatantly unfair to those individuals to penalize them for creating trusts for grandchildren which would have qualified for the grandchild's exclusion under the old generation-skipping tax law (which had the identical requirement that transfers be "to a grandchild") when there was nothing in the new generation-skipping tax law or comments to indicate that such transfers would not qualify for the $2,000,000 exemption. In fact, the clear implication was that these types of trusts would qualify.

The tax cost to an individual who transferred $2,000,000 to a trust for a grandchild, of which the trust property would in fact be included in the grandchild's estate if he or she dies prior to the trust's termination, is confiscatory if the transfer is not exempt from generation-skipping taxes. That is, not only would the gift tax (or estate tax) be due, but a generation-skipping tax of $1.1 Million Dollars would be due, despite the fact that the terms of the trust met all requirements which could reasonably be expected to be the requirements on transfers to a trust for a grandchild. In addition, a gift tax (or estate tax) would be due on the generation-skipping tax paid, resulting in another $500,000, more or less, in gift taxes (or estate taxes).

Conclusion. We believe the mandatory income payout requirement after age 21 is an unnecessary requirement and should not be added by the Technical Corrections Act. If such a requirement is added, we believe the age at which such payments should begin should be changed to a later age for policy reasons. If the mandatory income payout requirement is added for transfers to a grandchild, equity demands that a provision be added that with respect to transfers made before the date of enactment of the Technical Corrections Act, a trust which meets the first two requirements enunciated in the Technical Corrections Act would be treated as meeting all of the requirements for a trust to qualify for the grandchild exemption.

We appreciate your consideration of this matter.

Yours truly,

Diane W. Bricker H. Kate Hopkins

Diane W. Bricker H. Kate Hopkins

DWB/HKH:dhm

cc: Joint Committee on Taxation
Ms. Susan Hahn
Mr. Mel Thomas

The Catholic Church
EXTENSION Society
OF THE UNITED STATES OF AMERICA
35 East Wacker Drive • Chicago, Illinois 60601 • (312) 236-7240

BY EXPRESS MAIL

July 20, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance,
S.D. 205,
Washington, D. C. 20510

Dear Ms. Wilcox:

As president of THE CATHOLIC CHURCH EXTENSION SOCIETY OF THE UNITED STATES OF AMERICA, I am writing to you today to express my deep concern over the potential taxation of Charitable Gift Annuities.

Since 1905 the Extension Society, a non-profit Catholic charitable organization, has been raising funds to support the American home missions. Our work depends solely on the generosity of our donors.

One method of fund raising is through Charitable Gift Annuities. The donor wishes to help support the neediest people in our own country.

If Charitable Gift Annuities are taxed, Extension would lose an important source of revenue for our work. Some of the poorest people in rural America would suffer even more than they presently do.

A smaller donor, who is unable to establish a charitable remainder trust, which is unaffected by Section 501 (m), would be penalized. Of course, Extension Society and the poorest people in American would be penalized.

Please represent charitable organizations and lobby for the removal of Charitable Gift Annuities from IRC Section 501 (m).

Thank you for your help in this urgent matter.

Sincerely yours,

Very Reverend Edward J. Slattery
President

EJS:pa

Presented by
W. M. Harding, President
Central Bank for Cooperatives
Denver, Colorado

Mr. Chairman, I appreciate this opportunity to testify before you today and commend you for providing this forum to discuss a tax issue of importance to American agriculture.

My name is Malcolm Harding. I am president of the Central Bank for Cooperatives in Denver, Colorado, and I am appearing here today as a representative of the Farm Credit System's Legislative Committee.

My testimony concerns the need for a technical correction to the Tax Reform Act of 1986 to extend to the Farm Credit System the same right to use the reserve method of accounting for bad debts as granted to commercial banks of less than $500 million in assets.

I will focus on the impact on the Banks for Cooperatives and its borrowers, and David K. Kasten will discuss the impact on Production Credit Associations and the farmers they serve. The Banks for Cooperatives and the Production Credit Associations are part of the Farm Credit System which has experienced severe financial stress because of economic conditions in agriculture. The System has formally requested that Congress provide financial assistance so that the cooperative lending system can survive and continue to serve rural America.

Let me first provide some background on the Banks for Cooperatives and the cooperatives we serve.

The 12 district Banks for Cooperatives and the Central Bank for Cooperatives provide financial services to about 3,000 farmer-owned cooperatives and rural utility systems throughout the country. The banks currently have about $8 billion in loans outstanding.

The district Banks for Cooperatives are owned by the cooperatives they serve, and the district banks own the Central Bank. The Central Bank buys participations in large loans that exceed a district bank's lending limit. This is an important distinction because the Central Bank for Cooperatives is unique among financial institutions. Our bank does not make direct loans to cooperatives. We simply assist the district banks in meeting the credit needs of large cooperative borrowers.

The net income of the Central Bank is distributed to the 12 district Banks for Cooperatives and constitutes a major portion of the district banks' net income. The district banks distribute their income to the cooperatives which in turn distribute income to their farmer-members. Any impact on the Central Bank's income, such as that posed by the Tax Reform Act, significantly affects all cooperatives that borrow from the Banks for Cooperatives and ultimately the farmer-members of these cooperatives.

Agricultural cooperatives, rural utility systems, and the Banks for Cooperatives have a significant effect on the rural economy. Most farmers and ranchers are served by a marketing or farm supply cooperative, a rural electric cooperative, a rural telephone cooperative, or another type of farmer-owned cooperative. Many farmers and ranchers depend upon more than one cooperative for supplies or services necessary for their operations.

For example, Montana is served by over two dozen rural electric distribution cooperatives which provide electricity to rural areas. These cooperatives obtain their power requirements through ownership of a large generation and transmission cooperative that services rural electric co-ops in seven other states as well.

In addition, Montana has 70 farm supply cooperatives, 27 grain marketing cooperatives, and nine rural telephone co-ops.

It is safe to say that virtually every farmer and rancher in Montana is served by one or more of these cooperatives. In fact, with a cooperative, the users are the owners, so Montana farmers and ranchers have a direct stake in these businesses. It goes without saying that cooperatives are equally as important to farmers and ranchers in other farm states as well.

With this information about cooperatives as the backdrop, I want to briefly discuss the impact of the Tax Reform Act of 1986 on cooperatives that own and borrow from the Banks for Cooperatives.

The Tax Reform Act of 1986 inadvertently repealed the right of the Banks for Cooperatives and the Production Credit Associations to make deductions to maintain a reserve for loan losses. As a result, these institutions would have to recapture their reserves accumulated up to December 31, 1986, as income spread over four years, starting in 1987.

However, the reserve method of calculating bad debts was retained for commercial banks with less than $500 million in assets.

The new tax will have an impact of $54.5 million on the Banks for Cooperatives over the next four years. The total impact on the Production Credit Associations and the Banks for Cooperatives will be about $85 million.

The new tax penalty on the Banks for Cooperatives will ripple through the rural economy at a time when farmers and ranchers are struggling to survive. Because the Banks for Cooperatives are themselves cooperatives, they will have no choice but to pass the $54.5 million on to their owner-borrowers through higher interest rates. It is estimated that the tax will result in an increase in interest rates of about 20 basis points. Cooperatives, which will be faced with paying the higher interest rates, will be forced to pass the increased costs directly to farmers and ranchers.

The Farm Credit institutions clearly need a technical amendment to the Tax Reform Act of 1986.

Farm Credit institutions are truly financial institutions which raise their capital in the public capital markets and which have as their primary function providing credit and other financially related services to their borrowers.

The Tax Reform Act in amending code Section 585 only addressed the treatment of reserve for losses on loans of banks and used the traditional definition of bank as defined in code Section 581 as being an institution "a substantial part of the business of which consists of receiving deposits and making loans and discounts..." Therefore, code Section 585 does not apply to Farm Credit institutions because they are not banks for purposes of the Internal Revenue Code.

Furthermore, as indicated, the intent of Section 805 of the Tax Reform Act of 1986 was clearly to be effective for taxpayers other than commercial banks and by its very terms "taxpayers other than financial institutions."

Because neither cited section addressed the nature of Farm Credit institutions as being truly financial institutions, a technical amendment should be enacted which would allow Farm Credit institutions to continue to utilize the reserve method for losses and, in order to avoid the adverse financial impact on the Banks for Cooperatives and Production Credit Associations, would not require them to recapture reserves created prior to December 31, 1986.

Allowing Farm Credit institutions to be treated in the same manner as small banks for purposes of establishing reserves would address the technical problem concerning the appropriate code section which should be applied and would avoid the adverse financial impact by not requiring a recapture of a previously accumulated reserves.

During these extremely difficult times in American agriculture, the last thing farmers and ranchers and their cooperatives need is another tax to pay.

Mr. Chairman, I understand that you are considering the introduction of legislation to restore the reserve method of calculating bad debts for the Production Credit Associations and the Banks for Cooperatives.

We commend you for your concern for agriculture and rural America, and we urge you to extend your legislation to cover all of the Banks for Cooperatives and Production Credit Associations in the Farm Credit System and not limit it to institutions with less than $500 million in assets.

Three district Banks for Cooperatives have more than $500 million in assets, and the Central Bank has over $5 billion in assets. It is important to recognize that this results from the unique nature of the Farm Credit System. When Congress established the System it established 12 Farm Credit Districts with a Bank for Cooperatives serving each district. The Central Bank was established by Congress to serve all 12 district banks.

Merely because of the regions served by the three district banks these banks have more than $500 million in assets. This is a function of the number of cooperatives and especially the number of large regional cooperatives headquartered in these districts.

Some regional cooperatives serve wide geographic areas that include many states and overlap two or more Farm Credit districts. Nevertheless, a regional cooperative's loans are originated by the district that includes the co-op's home office.

To again use Montana as an example, Montana cooperatives are served, in effect, by two district Banks for Cooperatives and the Central Bank. While Montana is part of the Spokane Farm Credit

District, two major regional cooperatives that serve the state are headquartered in the St. Paul district. This is true also for the generation and transmission cooperative that provides the electricity that goes to most of the farms and ranches in Montana.

The Spokane Bank for Cooperatives has less than $500 million in assets while the St. Paul bank and the Central Bank exceed that amount.

Consequently, local cooperatives in Montana borrow from the Spokane bank but the regionals that serve these cooperatives borrow from the St. Paul bank and the Central Bank. The tax penalty would be passed to these co-ops through their regional cooperatives.

In contrast, cooperatives in the neighboring state of North Dakota would feel the impact of the new tax even more because both the local and regional cooperatives in that state are served by the St. Paul bank.

The effect of applying the $500 million cap to the Banks for Cooperatives is to negatively impact all farmers and ranchers served by cooperatives and to more severely impact those who live in the Farm Credit districts served by Banks for Cooperatives having more than $500 million in assets. Obviously, this is neither fair nor reasonable.

I urge the subcommittee to support a technical amendment to restore the reserve method of accounting to the Banks for Cooperatives and the Productions Credit Associations for the benefit of American farmers and ranchers.

Thank you for this opportunity to testify today. I would be happy to respond to any questions.

COMMENTS OF CENTEX CORPORATION
RE SECTION 811(c) OF THE TAX REFORM ACT OF 1986

Revised Special Effective Date Rule for
Installment Sales of Real Property by Dealers

Section 811(c) of the Tax Reform Act of 1986 (the "Act") contains the effective date provisions to be used in applying Section 811(a) of the Act (new section 453C of the Internal Revenue Code of 1986, as amended (the "Code"), relating to certain indebtedness treated as payment on installment obligations). Section 811(c) of the Act generally provides that, with certain exceptions, Section 811 of the Act will apply to taxable years ending after December 31, 1986, with respect to dispositions after February 28, 1986. Section 811(c)(6) of the Act generally provides that certain installment obligations with respect to the sale of real property in the ordinary course of a taxpayer's business will be taken into account ratably (i) over three years with respect to installment obligations arising in the first taxable year to which new section 453C of the Code applies and (ii) over two years with respect to the second taxable year with respect to which new section 453C of the Code applies.

Thus, with respect to a calendar year taxpayer, Section 811 of the Act applies to such taxpayer's taxable year ending December 31, 1987. However, with respect to a fiscal year taxpayer, Section 811 of the Act applies to such taxpayer's taxable year ending <u>in</u> 1987 because such taxable year is the first taxable year of the taxpayer ending <u>after</u> December 31, 1986. The interplay between this effective date and the phase-in of the reduced corporate tax rates under Section 601 of the Act and section 15 of the Code causes calendar year taxpayers to receive a tax benefit not available to fiscal year taxpayers, because gain associated with installment obligations of calendar year taxpayers will be taxed at lower corporate tax rates than comparable installment obligations of fiscal year taxpayers during the first two taxable years to which new section 453C of the Code applies.

However, certain fiscal year taxpayers currently have the ability to change their taxable year from a fiscal year to a calendar year without the prior approval of the Commissioner of Internal Revenue because such taxpayers meet the requirements for such change set forth in Treas. Reg. §1.442-1(c). Following such change in accounting period, such taxpayers will be in the identical tax posture under Section 811(c) of the Act as calendar year taxpayers.

Forcing qualifying fiscal year taxpayers to change their accounting period to the calendar year merely to achieve tax parity with calendar year taxpayers under Section 811(c) of the Act does not foster consistent tax policy and subjects those taxpayers to needless inconvenience. There should be no revenue loss if this change is made because these taxpayers will make the accounting period change if the requested technical correction is not made. In view of the foregoing considerations, the attached proposed statutory language would amend Section 811(c)(6) of the Act to give certain fiscal year taxpayers tax parity with calendar year taxpayers under new section 453C of the Code.

Section 811(c)(6) of the Tax Reform Act of 1986 would be amended to read as follows:

(6) SPECIAL RULE FOR SALES OF REAL PROPERTY BY DEALERS -

(A) IN GENERAL - Except as otherwise provided in subparagraph (B), in the case of installment obligations arising from the sale of real property in the ordinary course of the trade or business of the taxpayer, any gain attributable to allocable installment indebtedness allocated to any such installment obligations which arise (or are deemed to arise) -

(i) in the 1st taxable year of the taxpayer ending after December 31, 1986, shall be taken into account ratably over the 3 taxable years beginning with such 1st taxable year, and

(ii) in the 2nd taxable year of the taxpayer ending after December 31, 1986, shall be taken into account ratably over the 2 taxable years beginning with such 2nd taxable year.

(B) APPLICATION OF SPECIAL RULE TO CERTAIN FISCAL YEAR TAXPAYERS - In the case of a taxpayer who would be entitled, under section 442 of the Internal Revenue Code of 1986 and the regulations thereunder, to change its taxable year to the calendar year, effective January 1, 1987, without the consent of the Commissioner, this paragraph (c)(6) [Section 811(c)(6) of the Tax Reform Act of 1986] and paragraph (c)(1) [Section 811(c)(1) of the Tax Reform Act of 1986] shall be applied with respect to such taxpayer during the first three taxable years of the taxpayer beginning after December 31, 1986 (other than the portion of the third taxable year of the taxpayer after December 31, 1989), so that the portion of the tax liability of the taxpayer attributable to the allocable installment indebtedness of the taxpayer:

(i) shall first become taxable in the taxable year of the taxpayer beginning after December 31, 1986; and

(ii) shall be determined:

(I) for purposes of subsection (a) [Section 811(a) of the Tax Reform Act of 1986] as if the taxable year of the taxpayer had been changed to the calendar year, effective January 1, 1987; and

(II) by applying the tax rate to such portion as would be applied if the taxpayer had changed its taxable year as described in subclause (I) above.

SUMMARY OF ACCOMPANYING WRITTEN COMMENTS
OF CENTEX CORPORATION REGARDING
THE TECHNICAL CORRECTIONS ACT OF 1987

Section 453C of the Internal Revenue Code of 1986 (the "Code"), enacted under Section 811(a) of the Tax Reform Act of 1986 (the "Act"), relates to certain indebtedness treated as payment on installment obligations. Section 811(c) of the Act contains the effective date provisions to be used in applying new section 453C. As the attached comments note, the effective date provisions of Section 811(c) of the Act cause calendar year taxpayers to receive a tax benefit not available to fiscal year taxpayers, because gain associated with installment obligations of calendar year taxpayers will be taxed at a lower tax rate than comparable installment obligations of fiscal year taxpayers during the first two taxable years to which new section 453C of the Code applies.

However, certain fiscal year taxpayers currently have the ability to change their taxable year from a fiscal year to a calendar year without the prior approval of the Commissioner of Internal Revenue. Following such change in accounting period, such taxpayers will be in the identical tax posture under Section 811(c) of the Act as calendar year taxpayers.

Forcing these fiscal year taxpayers to change their accounting period to the calendar year merely to achieve tax parity with calendar year taxpayers under Section 811(c) of the Act does not foster consistent tax policy and subjects those taxpayers to needless inconvenience. There should be no revenue loss if this change is made because these taxpayers will make the accounting period change if the requested technical correction is not made. Section 811(c)(6) of the Act should therefore be amended to give certain fiscal year taxpayers tax parity with calender year taxpayers under new section 453C of the Code.

In the event any questions arise regarding these written comments, contact the following designated representative of Centex Corporation:

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July 8, 1987

Robert Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D. C. 20510

Re: Section 106(g)(5) of the
Technical Corrections Act of 1987

Dear Mr. Leonard and Ms. Wilcox:

I am involved in a situation whereby the enactment of Section 106(g)(5) of the TCA would cause a corporation which is now a "qualified corporation" under Section 633(d)(5) of the 1986 Act to cease to be a "qualified corporation." While I appreciate that the Conference Committee may perhaps be said to have intended this result, I am not convinced that it did, or that such a result is appropriate under the circumstances of this particular corporation's situation.

From 1953 to June 6, 1986 there were two 50% shareholders in the corporation. On that day the stock of one shareholder, then over 75 years of age, was completely redeemed for $1.5 million. Consequently, the second shareholder's ownership of the corporation's stock increased to 100% on, and has remained at 100% since, June 6, 1986, which of course would include August 1, 1986, a key date under Section 633(d)(5)(A) of the 1986 Act. The value of the 100% stock interest owned by the second shareholder, who is now over 70 years of age, has not been in excess of $2.2 million since August 1, 1986.

Under Section 633(d)(5) of the 1986 Act the corporation is now a "qualified corporation," because its sole shareholder has owned "more than" 50% of its stock since August 1, 1986, and the stock's value is less than $10 million. However, under Section 633(d)(5)(A) and (6)(A) of the 1986 Act, if amended by Section 106(g)(5)(A) and (B) of the TCA, the corporation would not be a "qualified corporation," because its sole shareholder has not owned "more than" 50% of its stock for five years; he has owned it for only 13 months.

Until the introduction of the Technical Corrections Act the corporation was negotiating the sale of its business with one buyer and the sale of its building with a second buyer. These negotiations have now been terminated solely as a result of the introduction of the TCA.

The June 6, 1986 action which disqualified the corporation, a redemption of 50% of its stock, was action which, indeed, made the corporation "smaller" based on the two criteria contained in Section 633(d)(5) of the 1986 Act: The number of its shareholders and its value. The corporation went from having two shareholders to having one shareholder, and its value decreased from $3.7 million to $2.2 million (a value which would entitle it to the full benefits of the transitional rule). Furthermore, on June 6, 1986 neither the House nor the Senate had devised any such transitional rule. Thus, there was no reason at that time to redeem less than all of the stock of the redeemed shareholder, action which would have avoided the adverse consequences of Section 106(g)(5)(B) of the TCA.

Furthermore, based on the Conference Committee's September 1986 description of the unenacted five-year rule, the corporation had reason to believe from that time until last month that it would be a "qualified corporation" even if a five-year rule were enacted. In this regard, the Conference Committee stated:

> "A corporation is eligible for this [transitional] rule if ... more than 50 percent of its stock is owned by 10 or fewer individuals who have owned their stock for five years or longer." [Emphasis added.]

More than 50% of the corporation's stock is (was) owned by a single shareholder (on August 1, 1986) who has owned their (his) stock (albeit not all of his stock) for over 30 years. Thus, the Conference Committee's language may be read to suggest that the Committee did not intend to go as far as unenacted H. Con. Res. 395 went in stating that qualified persons must have held "such stock" (i.e., more than 50%) for five years.

The result of Section 106(g)(5)(B) of the TCA could be reversed in the case of this corporation by a simple change: The language of Section 633(d)(6)(A) of the 1986 Act, as amended by Section 106(g)(5)(B) of the TCA, could refer to "50 percent or more" rather than "more than 50 percent."

Naturally, I have no idea as to the number of other corporations which would be similarly benefited by this change. However, most if not all of such corporations are probably "qualified corporations" under Section 633(d)(5) of the 1986 Act, and they would only be back where, based on the legislative language, they thought they were in the first place.

It is respectfully submitted that the language of Section 106(g)(5)(B) of the TCA penalizes a corporation which may indeed have been intended by the Conference Committee to be entitled to the "Transitional Rule for Certain Small Corporations," is clearly entitled to that rule under Section 633(d)(5) of the 1986 Act as enacted, and should not be retroactively denied the benefits of that rule more than seven months after enactment: A one-shareholder corporation with minimal value, in which the one shareholder (1) owned more than 50% of its stock on August 1, 1986, and (2) owned not less than 50% of its stock for more than 30 years.

Although this calendar year corporation elected status as an S corporation in December 1986, thereby permitting it to avoid the double tax created by repeal of the General Utilities doctrine by simply postponing the sale of its business and building to 1990, its 70-plus year old shareholder finds it difficult to understand why his corporation should no longer be a "qualified corporation." In effect, the TCA requires him to postpone the corporation's proposed sales for more than two years, or attempt to locate a purchaser of his stock. This shareholder is not assuaged by the knowledge that his corporation, by electing S corporation status in 1986 rather than now, has avoided the more severe ten-year waiting period applicable to late-electors.

The change suggested above to Section 106(g)(5)(B) would reverse what is considered by the shareholder to be not only an extremely unfair result, but much more than a "technical correction."

Very truly yours,

Martin A. Stoll

MAS:el

cc: Ms. Mary McAuliffe
Minority Chief of Staff
United States Senate
Committee on Finance
Room SD-G08
Washington, D. C. 20510

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MEMORANDUM

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July 24, 1987

Extraordinary Dividends:
Comments on Section 106(c)(3) of the
Technical Corrections Bill of 1987

We would like to propose a revision to Section 106(c) of the Technical Corrections Bill of 1987, which revises Section 1059(d)(7) of the Internal Revenue Code of 1986 and redesignates it as Section 1059(d)(6). The discussion below focuses on revised Section 1059(d)(6) as contained in the Technical Corrections Bill.

Section 1059(d)(6), which contains a special exception to the general rule of Section 1059, provides that no basis reduction is required in the case of an otherwise extraordinary dividend received with respect to stock if: (a) the taxpayer has held the stock during the entire period such corporation was in existence, and (b) the earnings and profits from which the dividend is paid could not have been attributable to any person other than the original shareholder receiving the distribution. As a result, Section 1059(d)(6) relief is limited to the narrow class of equity investors who are committed to, and bear the risk of, a corporation's business from its inception. Unfortunately, if Section 1059(d)(6) is applied literally, Section 1059(d)(6) relief would not be available in most situations for which it was intended.

Four examples of very common situations will illustrate this point. In the <u>first example</u>, a shareholder purchases preferred stock a few days after the corporation is formed and the common stock is issued to the common stock shareholder. In the <u>second example</u>, a shareholder purchases the stock of a shelf corporation that had been formed some months previously. In the <u>third example</u>, a shareholder purchases preferred stock of a corporation that for some time had been an inactive member of a consolidated group. In the fourth example, a shareholder purchases the stock during the time in which the corporation is engaging in such preliminary activities as negotiating contracts, securing suppliers and customers and sources of funding but prior to the time in which it is capable of engaging in the business activities for which the corporation has been formed.

This fourth example is very common since the various participants in a venture, e.g., debt, equity, suppliers, contractors and customers, often will not commit themselves unless all the other parties are simultaneously committed. Such ventures are typically put together in a series of more or less simultaneous closings which take place after weeks or months of negotiations.

For example, our client is in the business of building and operating large cogeneration facilities. Each cogeneration facility is constructed and owned by a separate corporation ("Subsidiary") established solely for this purpose. Typically our client spends many weeks or months locating the project, negotiating for the acquisition of the land, negotiating the fuel supply contract, power supply agreements and construction agreements, and securing sources of funding. All of these different elements are brought together at a series of more or less simultaneous closings in which the various agreements are signed and the debt and equity players agree to funding levels. Although all these preliminary activities are carried out on behalf of the Subsidiary, the Subsidiary is not really in a position to begin conducting business until such closings. If the negotiations with any of the parties fall through prior to closing and a substitute party cannot be found, the project must typically be abandoned or restructured.

We submit that equity investors who either acquire stock on or before such closing, or who enter a binding contract on or before such closing to acquire stock, should be treated for purposes of Section 1059(d)(6) as if they held such stock for the entire existence of the corporation and should be accorded relief under Section 1059(d)(6). We would include within this rule equity investors who have entered into a binding contract to acquire stock since such investors are committed to, and bear the risk of, the venture for the requisite period. In this context, such a binding commitment carries with it the requisite incidents of stock ownership. There should be no policy reason why such investors should not be afforded relief under this provision merely because the venture was able to rely on their commitment and did not require them to immediately fund their commitment with capital.

We would propose handling this issue by inserting language along the following lines in the committee report discussion of proposed Section 1059(d)(6):

> "For purposes of this provision, a shareholder will be treated as holding stock on the first day of a corporation's existence if such shareholder acquires the stock prior to the time the corporation engages in any significant business activity other than preliminary activities. Preliminary activities are those incident to the start-up of business operations, such as soliciting and securing customers and suppliers; negotiating and concluding contracts which are necessary or useful for the business; securing sources of funding and necessary permits or approvals; interviewing and hiring employees; and securing office space or other facilities. The corporation will not be deemed to be engaged in preliminary activities once it is in a position to commence the business activities for which it has been formed. A taxpayer will be deemed to hold stock in the corporation for purposes of this provision beginning on the date on which he enters into a contract which is binding on such taxpayer to purchase such stock."

William G. Cavanagh

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DEPARTMENT OF CHILD HEALTH AND DEVELOPMENT, GEORGE WASHINGTON UNIVERSITY
CHILD HEALTH CENTER ● RESEARCH FOUNDATION OF CHILDREN'S HOSPITAL

July 16, 1987

James C. Gould, Chief Tax Counsel
U.S. Senate Committee on Finance
Dirkson Senate Office Building, Room 205
Washington, D.C. 20510

Dear Mr. Gould:

Please amend the Technical Corrections Bill (S. 1350) to clarify that charitable gift annuities issued by IRC Sec 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

Charitable gift annuities do not compete with commercial annuities and are not "commercial-type insurance." They have been used by charitable organizations for over 100 years and are an important source of funds in a comprehensive development program.

Charitable gift annuities enable a moderate income donor to make significant gifts to his favored charities that would otherwise be impossible. For him, it is the equivalent of a high income donor's charitable remainder annuity trust -- which remains untouched by IRC Sec. 501(m).

In the interest of preserving a crucial component of our total fund-raising strategy, we urge the Senate Committee on Finance to make the requested amendment to the Technical Corrections Bill.

Sincerely yours,

Terry L. Lierman
Chairman, Development Council

Thomas D. Walsh
Chairman, Board of Directors

TLL/TDW:sb

Christian Church Foundation

(Disciples of Christ)

James R. Reed
President

June 29, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I am writing to you on behalf of the entire staff of the Christian Church Foundation, the foundation unit of the Christian Church (Disciples of Christ). We have been and continue to be concerned about possible misinterpretation of IRC Sec. 501(m) of the Tax Reform act of 1986 which would treat charitable gift annuities as "commercial-type insurance."

We are asking that the Technical Corrections Act of 1987 (H.R. 2636) be amended to clarify that charitable gift annuities are not subject to IRC Sec. 501(m).

Misinterpretation of IRC Sec. 501(m) could cause our organization to have to refuse acceptance of these forms of gifts. For the small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501(m). Gift annuities allow those smaller donors to make gifts to help support our churches and the programs we represent. These types of gift annuities are not "commercial-type insurance" and do not compete with commercial annuities.

Gift annuities have been used by charitable organizations for over 100 years. Please do what you can to get the Technical Corrections Act of 1987 amended so that our gift annuity program can continue to be a source of funds for the Disciples' charitable activities.

We thank you in advance for your help.

Sincerely,

James R. Reed

James R. Reed, President
jk

222 South Downey Avenue, P.O. Box 1986, Indianapolis, IN 46206, (317) 353-1491

COMMENTS
OF
CHURCH ALLIANCE
ON
TECHNICAL CORRECTIONS ACT OF 1987 (H.R. 2636, S. 1350)

The Church Alliance is an organization consisting of the chief executive officers of the pension boards of 28 mainline church denominations having over 65 million members. We ask consideration of the following points for inclusion in the Technical Corrections Act of 1987.

1. Church Self-Funded Death Benefit Programs. Several church death benefit programs are provided either by the church directly or by a church pension board, rather than through the purchase of commercial life insurance. The Deficit Reduction Act of 1984 amended the definition of "life insurance contract" in section 7702(a) to include a requirement that the contract be a life insurance contract under the "applicable law", that is, state or foreign law. This applicable law requirement is extremely troublesome. It means that because church ministers and lay workers reside in all 50 states, the law of each state must be examined to determine whether the church's death benefit program is treated as a life insurance contract under the applicable law. The law of some states is clear that such treatment is available. However, the law in other states on this point is either nonexistent, unclear, or adverse. The result of the "applicable law" requirement will thus be nonuniformity in tax treatment of the proceeds payable under church death benefit programs.

We believe that DEFRA did not intend to prohibit a self-funded death benefit plan from being a life insurance contract for purposes of sections 101(a) and 79, but rather was intended to prescribe rules to restrict the use of so-called life insurance contracts that are essentially investment vehicles. Church self-funded death benefit programs contain no investment or cash value element.

Senator Durenberger has introduced S. 1263, a bill which would clarify the "applicable law" requirement for church self-funded death benefit programs. The Church Alliance urges that S. 1263 or similar legislation to accomplish the same result be incorporated in the Technical Corrections Act. We note that the Technical Corrections Act contains technical amendments to DEFRA. Thus, inclusion of S. 1263 or similar legislation in the current Technical Corrections Act is appropriate.

2. Unfunded Deferred Compensation Plans of Churches and Church-Related Oranizations. The Church Alliance strongly disagrees with the position taken by the Department of the Treasury in Notice 87-13 (January 5, 1987) that section 457 applies to any amount of compensation deferred under a deferred compensation plan, including a deferred compensation agreement or arrangement, whether or not such agreement or arrangment is individually negotiated. The Church Alliance believes that the Revenue Act of 1978 (which introduced section 457 into the Code), the Tax Reform Act of 1986 (which did not change the scope of section 457), and the underlying legislative history of both Acts require only those amounts of compensation which are deferred under the individual option of an employee to be subject to section 457. The Technical Corrections Act should make this point clear by reversing the position taken in Notice 87-13 on this issue.

Moreover, the Church Alliance objects to the application of section 457 to churches and church-related organizations. This in effect, eliminates a vital method of enhancing the retirement benefits of ministers and lay employees. The Church Alliance sees no justification in treating tax-exempt employers and their employees more severely than taxable employers and their employees with respect to unfunded deferred compensation.

We are aware that the section 457 Task Force has filed comments on this issue. We have reviewed its comments and fully support them.

3. Specific Removal of Charitable Gift Annuities from the Operation of Section 501(m). The Church Alliance strongly supports "providing annuities that meet the tests described in section 514(c)(5)" as a specific exception from the definition of commercial-type insurance under section 501(m)(3). For over 100 years, the charitable gift annuity has been an important means to charitable organizations for raising modest gifts. The transaction arises when a donor wants to benefit a favorite charity but cannot afford to live without the income from the gift. He makes a gift of cash or property but reserves an annuity, which is valued at significantly less than the amount of the transfer. The donor is thinking in terms of benefiting a charity rather than of buying an annuity.

A charitable remainder annuity trust produces substantially the same results as a charitable gift annuity but is outside the purview of section 501(m). However, because of the expenses of creating and administering it, a viable charitable remainder annuity trust cannot be created unless the gift is substantial. The charitable gift annuity is nothing more than a poor man's charitable remainder annuity trust.

Since 1969 section 514(c)(5) had defined the type of charitable gift annuity that should be subject to the unrelated business income tax. Therefore, the Church Alliance believes that Congress in 1986 did not envision subjecting charitable gift annuities to section 501(m).

There can be no revenue loss from a provision excepting charitable gift annuities from the term "commercial-type insurance" since it would not appear that any revenue was projected from this source in the beginning.

4. Participation Rules for Church Section 403(b) Annuity Programs. The Church Alliance notes that there is a question under section 403(b)(12)(A) (as redesignated by the Technical Corrections Act) whether the participation rules of section 410(b) or the pre-ERISA participation rules (see section 410(c)(2)) apply to those contracts which are not purchased by a "church" as defined in section 403(b)(12)(B) but which are provided under a church plan. The Church Alliance believes that the pre-ERISA participation rules should apply to those contracts, and this should be clarified in the Technical Corrections Act.

CHURCH ALLIANCE

By Gary S. Nash
Gary S. Nash, Secretary

SUPPLEMENTAL STATEMENT OF
CHURCH ALLIANCE
FOR COMMENTS ON
TECHNICAL CORRECTIONS ACT OF 1987
(H.R. 2636, S. 1350)

1. Designated representative:

Gary S. Nash, Esquire
General Counsel and Secretary
Annuity Board of the
Southern Baptist Convention
511 North Akard, Suite 511
Dallas, Texas 75201

Telephone No.: 214-720-2140

2. Capacity of designated representative:

Secretary, Church Alliance

3. Summary of Comments:

a. Church Self-Funded Death Benefit Programs. The Deficit Reduction Act of 1984 amended the definition of "life insurance contract" in section 7702(a) to require that the contract be a life insurance contract under the "applicable law", a rule possibly requiring that the law in all 50 states be examined, with resulting nonuniformity in the tax treatment of church self-funded death benefit plans. The "applicable law" requirement was not intended to prohibit church self-funded death benefit plans from being life insurance contracts for purposes of sections 101(a) and 79 and is properly subject to technical correction.

b. Unfunded Deferred Compensation Plans of Churches and Church-Related Organizations. Section 457, as amended by the Tax Reform Act of 1986, applies restrictive rules to the unfunded deferred compensation plans of tax-exempt organizations. The Church Alliance disagrees with the Treasury in Notice 87-13 that section 457 applies to elective as well as nonelective deferred compensation plans. Moreover, the Church Alliance objects to the application of section 457 to churches and church-related organizations. There is no justification in treating tax-exempt organizations and their employees more severely than taxable organizations and their employees, which are not subject to section 457.

c. Specific Removal of Charitable Gift Annuities from the Operation of Section 501(m). The provision of charitable gift annuities should be specifically exempted from the operation of section 501(m) by exclusion of such annuities from the definition of commercial life insurance. Section 501(m) was not intended to destroy a means of raising modest gifts for charitable organizations which has existed for over 100 years.

d. Participation Rules for Church Section 403(b) Annuity Programs. The Church Alliance believes that, where applicable, the pre-ERISA participation rules (i.e., section 401(a)(3) as in effect on September 1, 1974) and not section 410(b) should apply to church section 403(b) annuity programs, as provided clearly in section 410(c)(2).

William J. Wilkins, Esquire
Chief Counsel
Committee on Finance
U.S. Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Submission for the Record on S. 1350
Regarding a Technical Correction to
Eliminate Retroactive Certification
of Employees for Purposes of the WIN Credit

Dear Bill:

On behalf of C.I.C. Enterprises, Inc. and Government Program Services, Inc., employment consulting firms that assist taxpayers with respect to WIN and targeted jobs tax credits, we are submitting the following comment on S. 1350 regarding a technical correction to eliminate retroactive certifications of employees for purposes of the WIN credit. The comment, as more fully described below, points out that our suggested correction, which is currently embodied in H.R. 2111, introduced by House Committee on Ways and Means Chairman Rostenkowski, represents an equitable compromise by effecting a technical change in the law that should increase future tax revenues while providing only prospective termination of a practice that taxpayers have justifiably relied upon.

Background

Under sections 40 and 50A(a),1/ employers were allowed a credit, subject to certain limitations, equal to the sum of 50 percent of the first-year "work incentive program expenses" and 25 percent of the second-year "work incentive program expenses." Section 50B(a) provided that the term "work incentive program expenses" meant "the amount of wages paid or incurred by the taxpayer for services rendered by "eligible employees." Section 50B(h)(1) defined the term "eligible employee" as an individual (emphasis added) --

> (A) who has been certified by the Secretary of Labor or by the appropriate agency of state or local government as--
>
> (i) being eligible for financial assistance under part A of title IV of the Social Security Act as having continually received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or
>
> (ii) having been placed in employment under a work incentive program established under Section 432(b)(1) of the Social Security Act,

* * * *

The statute itself contained no requirement that employee certifications be obtained prior to employment. Similarly, the legislative history of section 50B(h)(1) is

---

1/ All section references are to the Internal Revenue Code of 1954, as amended.

devoid of any suggestion of a requirement that employee certification be obtained prior to employment. Thus, it seems clear that the credit is available if an otherwise eligible employee is certified at any time before the claim for the credit is ultimately allowed by the Internal Revenue Service.

The Internal Revenue Service, in two private letter rulings, acknowledged that certifications obtained after employment were valid for purposes of the targeted jobs tax credit (the "TJTC") under section 51, which contained certification requirements very similar to those in section 50B(h)(1):

> "A review of the targeted jobs credit history shows that initially there was no provision concerning the timeliness of certifications. The SESAs were allowed to issue certifications to employers retroactively even if the employer did not request the certification before the individuals began work. . . ." PLR 8414024 (December 30, 1983) (emphasis added). Similarly, PLR 8432065 (May 8, 1984).

Because the WIN credit was almost identical to the TJTC, section 261(g)(1)(B) of the Economic Recovery Tax Act of 1981 ("ERTA"), P.L. 97-34, 1981-2 C.B. 256, 304, added WIN registrants to the list of target groups covered by the TJTC by providing that WIN registrants be added to the list of target groups, but only for tax years beginning after December 31, 1981. In addition, ERTA section 261(c)(1)(A) amended section 51 to require that certifications be obtained prior to employment for purposes of the TJTC, but provided a transition period during which employers could obtain valid certifications for employees hired prior to the passage of ERTA. No similar requirement or transition period was enacted with respect to the WIN credit for taxable years beginning before January 1, 1982. The failure of Congress to enact similar rules for WIN credits claimed under sections 40, 50A and 50B for taxable years beginning prior to January 1, 1982, suggests that Congress did not desire to change retroactively the WIN credit certification requirements.

The Joint Committee Explanation of ERTA (i.e., the "Blue Book") reiterates the tax act's statutory language in more generic terms by providing that the WIN credit is merged into the TJTC for amounts paid or incurred in taxable years beginning after December 31, 1981. Accordingly, for taxable years beginning before January 1, 1982, the pre-ERTA WIN credit provisions (sections 40, 50A and 50B), and not the TJTC provision (section 51), continue to apply in regard to both the computation of the WIN credit in the first and second years of employment and the certification requirements for qualified employees hired during that time.

In General Counsel's Memorandum (G.C.M.) 36904, published on March 11, 1987, the Office of the Chief Counsel of the Internal Revenue Service has taken the position that certification of employees prior to employment was required under section 50B as it was originally enacted. G.C.M.

36904, however, does not satisfactorily explain the basis of this contention and does not even discuss the relevance of the new pre-employment certification requirement added by ERTA. The G.C.M. therefore provides a misleading and incomplete analysis of the WIN credit law with respect to employee certifications.

Taxpayers have relied upon the fact that the WIN credit provisions were not retroactively amended by ERTA and have filed claims for WIN credits for which they justifiably believe they are entitled. We are aware that many of these taxpayers have had their claims approved by the Internal Revenue Service, while others are currently being denied.

H.R. 2111

As introduced by Chairman Rostenkowski, H.R. 2111, would codify the position taken in G.C.M. 39604 that the WIN credit is not available with respect to any employee for whom the employer did not request or obtain certification on or before the date the individual commenced work for the employer. However, the bill would make this change effective only for WIN credits first claimed after March 11, 1987, the date G.C.M. 39604 was first published.

H.R. 2111 would apply for purposes of the WIN credit the principle that Congress passed in ERTA with respect to the TJTC. In so doing, the bill would prevent taxpayers from claiming previously available WIN credits and therefore would produce additional tax revenues. At the same time, the bill, by making the amendment effective only for credits first claimed after March 11, 1987, recognizes the reliance that taxpayers have placed on the availability of the WIN credits and the lack of a transition period (such as that provided by ERTA for the TJTC).

We appreciate the opportunity to comment upon the technical connections legislation.

Sincerely,

Jerry

N. Jerold Cohen
Sutherland, Asbill
& Brennan

John J. Salmon
Dewey, Ballantine, Bushby,
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Richard P. Traina, President

Telephone (617) 793-7320

July 9, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I am writing as President of Clark University to express concern over the just-released Technical Corrections Bill which, if enacted, would severely restrict the creation of Charitable Lead Trusts.

As proposed, the Technical Corrections Bill would repeal the charitable deduction in computing the generation-skipping transfer tax on lead trusts created after June 10, 1987. Removing this deduction would discourage our donors from establishing these trusts, which provide Clark with a guaranteed income over a period of years and, through the same device, provide for the donors' heirs in later years (often to cover the expenses of college education).

The Charitable Lead Trust is an important option for major donors to our University - a small, private coeducational, liberal arts institution. Our ability to maintain and improve academic standards and to provide scholarships for undergraduate study and graduate research is directly tied to our ability to raise funds. I urge you to amend the Technical Corrections Bill so that the Charitable Lead Trust is preserved as an effective giving method.

Cordially,

Richard P. Traina

RPT/lk

cc: The Honorable Edward M. Kennedy
The Honorable John F. Kerry

STATEMENT OF BAKER & MCKENZIE CONCERNING AMENDMENTS TO THE PASSIVE FOREIGN INVESTMENT COMPANY PROVISIONS

submitted to

THE SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

July 24, 1987

I. Introduction.

Baker & McKenzie represents the Coalition to Exclude Operating Income from the PFIC Provisions. The Coalition consists of over a dozen United States-based corporations competing in overseas markets. The Coalition was organized because the Passive Foreign Investment Company ("PFIC") provisions enacted as section 1235 of the Tax Reform Act of 1986 (codified as sections 1291-1297 1/) would classify many of the members' foreign operating subsidiaries as PFICs. Such classification would subject them, in effect, to current U.S. taxation on the operating income of their foreign subsidiaries. The Coalition believes such a result was not intended by Congress.

The central purpose of the PFIC provisions is to insure that passive income earned by U.S. taxpayers through investments in foreign mutual funds does not benefit from deferral of current U.S. taxation. The Subpart F provisions of the Code (sections 951-964) achieve this result in the case of U.S. shareholders (as defined in section 951(b)) holding investments in controlled foreign corporations ("CFCs") (as defined in section 957), by requiring current U.S. taxation of passive income earned by such CFCs. Therefore, the true target of the PFIC provisions were U.S. taxpayers who were able to avoid application of the Subpart F provisions as well as other anti-abuse provisions of the Code.

All the members of the Coalition are U.S. shareholders with respect to their foreign operating subsidiaries, which subsidiaries are CFCs. Thus, any passive income earned by their CFCs are subject to current U.S. taxation under the Subpart F rules. Because of this simple fact, neither the House nor the Senate provisions dealing with PFICs had any effect on, or application to, taxpayers who were already subject to the provisions of Subpart F.

The Conference Agreement, as summarized in August 1986, did not indicate that this aspect of the PFIC provisions had been altered in any way by the Conferees. However, the final version of the statutory PFIC provisions, by leaving out a provision in the Senate Bill on which the final version was supposedly based, created a situation in which the income from active operations of CFCs would be treated under the PFIC rules as if it were "passive" income.

Accordingly, a technical amendment, modeled on the provision in the Senate Bill left out of the final statute, is necessary to assure that the PFIC provisions do not apply to U.S. shareholders of CFCs.

II. Analysis.

A. The House Bill.

The House was concerned generally that certain well-placed individuals could invest in offshore mutual funds holding passive assets in a manner that allowed them to defer taxation on current income of the funds and to repatriate such income at favorable capital gains rates. The Subpart F, personal holding company, and foreign personal holding company provisions, designed to require current inclusion of passive income, could be avoided by keeping U.S. owners as a minority of the shareholders of the offshore fund. Further, the foreign investment company provisions of section 1246, designed to require ordinary income treatment on gains from the sale of offshore mutual fund stock, could be avoided by keeping U.S. ownership of the investment fund at half or less and by limiting the total number of U.S. persons investing in the fund to fewer than 100. Because of these various limitations, this loophole was available only to a few well-placed Americans. The House thought this loophole was unfair, and closed it. 2/

The House Bill accomplished this by defining offshore mutual funds as PFICs. Such funds and their shareholders had not previously been subject to the Subpart F provisions; under the House Bill, they were made fully subject to Subpart F, and gain on sale or redemption of PFIC stock was treated as ordinary income. The result was that U.S. investors in offshore mutual funds would be currently taxable on the fund's income, all of which would normally be passive, and would be taxed at ordinary rates on any gain from the sale or redemption of shares in such a fund.

Because the House Bill addressed the problem by subjecting the funds and their shareholders to the Subpart F provisions, it had no impact on those taxpayers who were already U.S. shareholders of CFCs.

The House Bill and its legislative history contained no hint that the normal rules for taxing CFCs and their shareholders already subject to Subpart F were to be altered by the PFIC rules.

Significantly, the revenue estimate for the House Bill's provision was only $85 million over five years, thus clearly signifying the limited nature of the loophole being closed.

B. The Senate Bill.

The Senate Bill also closed the loophole identified by the House Bill, and for the same reasons, but did so in a substantially different manner. Nevertheless, it retained the House Bill's definition of a PFIC, and subjected holders of PFIC stock to a regime of taxation similar to that appearing in the PFIC provisions as finally enacted.

Most importantly, however, the Senate Bill specifically excluded U.S. shareholders of CFCs from the application of the PFIC provisions, apparently on the theory (obviously accurate) that such U.S. shareholders were already subject to current U.S. taxation on any passive income earned by their CFCs, and ordinary income treatment (via the gain recharacterization rules of section 1248) on any gain from a disposition of CFC stock. 3/

Moreover, the Senate Bill permitted any taxpayer otherwise subject to the PFIC rules to elect to be treated as a U.S. shareholder of a CFC, so that Subpart F, and not the PFIC provisions, applied. As was the case in the House, there was no hint of any intent to subject U.S. shareholders of CFCs to current taxation on the operating income earned by their CFCs. To the contrary, the election to be treated under Subpart F rather than the PFIC rules, which was available to all U.S. persons who were not U.S. shareholders in CFCs, constituted an affirmative recognition by the Senate that such income need not be subject to current inclusion.

Again indicating the limited nature of the loophole being closed, the Senate estimated that the total revenue pickup from the PFIC provisions would be $82 million over a five-year period.

C. The House and Senate Bill Compared.

A comparison of the PFIC provisions in both the House and Senate Bills reveals two important conclusions: First, both chambers agreed that the PFIC provisions should not affect the taxation of U.S. shareholders of CFCs. Second, both chambers agreed that the application of the Subpart F rules was a complete remedy for the loophole identified. On this latter point, the House signified this intent by actually placing PFICs and their shareholders under the Subpart F rules, while the Senate did so by making Subpart F an alternative at the option of the taxpayer.

From this, it is clear that it was never the intent of either the House or the Senate to subject U.S. shareholders of CFCs to current U.S. taxation or a deferred interest charge on the operating income of their CFCs under the PFIC rules.

D. The Conference Agreement of August 16, 1986.

When the House-Senate conferees met to resolve differences between the two versions of the tax reform bill, they had only the texts of the House and Senate bills to consider. In arriving at the final bill, they did not consider statutory language, but rather worked from summaries.

On August 16, 1987, the staff of the Joint Committee on Taxation issued, at 8:30 P.M., a summary of the final agreement by the House-Senate conferees on the tax reform provisions (the "August 16 Summary"). It is this document which was the basis for the formal Conference approval of the Tax Reform Act that occurred later that same evening. The full text of the August 16 Summary with respect to the PFIC provisions was as follows:

> 8. Foreign investment companies
>
> Tentative agreement.--Generally, House recedes but with restrictions (including requirement that foreign fund furnish information) on the identification of income character and with technical amendments.

August 16 Summary at 61.

This short statement indicates that the provision in the Senate Bill exempting U.S. shareholders of CFCs from the application of the PFIC rules was retained in the final

Conference Agreement. The elimination of such exemption is not specifically mentioned, and such elimination, which would greatly expand the scope of the PFIC rules, cannot reasonably be called a "technical amendment."

E. The Final Statute.

The statutory language of the PFIC provisions as finally drafted differed substantially from the Senate Bill's provisions. Importantly, the provision contained in the Senate Bill exempting U.S. shareholders of CFCs was omitted.

The Conference Report, published simultaneously with the Act, gives no hint that U.S. shareholders of CFCs would be subject to the PFIC provisions. In fact, it discusses the provision solely in the context of passive offshore investment funds. The Report states:

> The conferees believe that eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds.

H.R. Rep. No. 841, 99th Cong., 2d Sess. II-641 (1986).

The Conference Report also states that: "The conferees do not intend that foreign corporations owning the stock of subsidiaries engaged in active businesses be classified as PFICs." Id. at II-644. Nevertheless, as described below, the omission from the Act of the Senate Bill provision exempting U.S. shareholders of CFCs will have that result unless the omission is corrected.

F. Congressional Approval of Deferral--Subpart F.

Subpart F was passed in 1962 so as to eliminate the use of foreign subsidiaries to obtain deferral of U.S. tax, where such subsidiaries were engaged in specified "tax haven"-type activities or earned specified "tax haven"-type income. Since 1962, Subpart F has served to guard against the use of a foreign corporation to obtain deferral of U.S. tax with respect to types of activities or income that Congress believed should be subject to current U.S. tax. In this regard, Congress has refined the definition of "Subpart F income," i.e., income subject to current inclusion in the U.S. shareholder's income under the rules of Subpart F, over the years, most recently in the Tax Reform Act of 1986, to assure that U.S. shareholders cannot use CFCs to gain the benefit of deferral on passive investment income and carefully defined categories of foreign base company income.

Importantly, however, Congress has always permitted deferral of U.S. taxation on operating income not included in the definition of Subpart F income. In both 1962 and 1976, Congress was presented with the option of eliminating deferral on all income of foreign subsidiaries regardless of its type, and it considered the matter on an in-depth basis both times. Both times it rejected the elimination of deferral with respect to operating income generally as being against the interests of the United States in promoting the international competitiveness of United States business.

The evolution of Subpart F represents the direct and cumulative judgment of Congress as to what types of income should be subject to current U.S. tax when earned by foreign subsidiaries of U.S.-based multinational corporations. 4/ Indeed, in light of this background, it is not surprising that neither the House nor the Senate bills, in their PFIC provisions, would have affected U.S. shareholders of CFCs who were already covered by the Subpart F provisions. It is surprising, however, that the Conference bill would effectively reverse the long-standing Congressional judgment that operating income of CFCs generally should not be taxed currently to their U.S. shareholders.

G. The Effect of the Asset Test on Operating Companies.

Unfortunately, the PFIC provisions as enacted, if not corrected, would effectively override Congress's judgment that non-Subpart F income should be eligible for the benefit of deferral. In effect, the PFIC provisions would swallow up the careful distinctions made by Subpart F, subjecting all income of CFCs, regardless of type, to the economic equivalent of current U.S. taxation. For instance, a wholly owned foreign manufacturing subsidiary of a U.S. corporation could quickly become a PFIC because of its accumulation of assets not directly used in its day-to-day business. This result occurs because of the mechanical operation of the asset test, when unchecked by an exemption for U.S. shareholders of CFCs.

Under the asset test, any foreign corporation is a PFIC if half or more of the average value of its assets consists of assets producing passive income or assets held for the production of passive income. Thus, if an active CFC accumulates profits with a view to further expansion of its operations, it could quickly find itself a PFIC if its operations are particularly profitable. Further, certain assets, such as trade accounts receivable, often account for a substantial portion of the "asset" value of a CFC, and such assets might well be classified as passive assets under the PFIC rules. 5/ Similarly, manufacturing facilities which are temporarily closed, real estate purchased with a view towards construction of new manufacturing facilities in the future, and the like, could result in PFIC status for a CFC which is in an active business.

H. Status as Technical Amendment.

As demonstrated above, neither the House nor the Senate ever indicated any intention that U.S. shareholders of CFCs be subject to the PFIC rules. Rather, they consistently indicated that Subpart F was the exclusive and adequate safeguard against tax abuse in such situations. The Conference Agreement, as expressed in August, clearly envisions the incorporation of the provisions of the Senate Bill in the final Act, and this must have included an intent to retain the exclusion from the PFIC rules found in the Senate Bill, in view of the fact that there was no difference between the House and Senate Bills on this point.

Subpart F has for twenty-five years expressed Congress's considered policy judgment with regard to the proper taxation of U.S. shareholders of CFCs. This was recognized by both the House and Senate Bills. A major reversal of this policy is nowhere hinted at in the legislative history of the PFIC provisions. Rather, that history, fairly read, indicates that those provisions are directed solely at taxation of passive income earned through offshore mutual funds and similar types of passive investment vehicles.

It is simply incomprehensible that such a major change in the tax regime governing U.S. shareholders of CFCs could have occurred intentionally without some discussion or some hint that Congress so intended. Rather, it seems obvious that the omission of the provision in the Senate Bill exempting U.S. shareholders of CFCs from the PFIC provisions was an oversight.

Further evidence that this omission was unintentional may be gleaned from the fact that the revenue estimate appearing in the Conference Report was only $82 million over a five-year period--exactly the same estimate as contained in the Senate Finance Committee Report. The expansion of the PFIC rules to cover the operating income of foreign operating subsidiaries, as compared to the Senate or House Bills, would clearly result in substantially higher revenues. Consequently, it seems obvious that the only intended target of the PFIC provisions was the original loophole identified by the House.

III. Recommended Amendment.

Accordingly, the Coalition submits that the following amendment to section 112(n) of the Technical Corrections Act should be added to that Act: 6/

> (25) Subsection (b) of section 1297 of the 1986 Code is amended by adding at the end thereof the following new paragraph:
>
> "(9) EXCEPTION WHERE SECTION 951 APPLIES.--This part shall not apply to a taxpayer with respect to a corporation if, without regard to this Part--
>
> "(i) such corporation is a controlled foreign corporation (as defined in section 957), and
>
> "(ii) the taxpayer is a United States shareholder (as defined in section 951(b)) with respect to such corporation."

As noted, this amendment is copied from the Senate bill provision, and, accordingly, would achieve the intent of Congress with respect to U.S. shareholders of CFCs. We respectfully request that the Senate Finance Committee adopt this amendment as part of the Technical Corrections Act.

Respectfully submitted,

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Attorneys for the Coalition to Exclude Operating Income from the PFIC Provisions

FOOTNOTES

1/ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986.

2/ H.R. Rep. No. 426, 99th Cong., 1st Sess. 408-09 (1985).

3/ H.R. 3838, § 925(a) (Code section 1246A(h)(4)) (Senate Bill). S. Rep. No. 313, 99th Cong., 2d Sess. 397 (1986).

4/ Notably, these safeguards include requiring current inclusion of all of a CFC's income in the taxable income of its U.S. shareholders where the CFC is used primarily (but not exclusively) to earn tax haven-type income, that is, where more than 70 percent of the CFC's gross income is tax-haven-type income. § 954(b)(3)(B).

5/ See section 954(c) (defining non-income-producing assets as "passive" assets).

6/ This amendment is identical to the exclusion in the Senate Bill, H.R. 3838, § 925(a) (Code section 1246A(h)(4)) (Senate Bill), with the exception that the term "Part" has been substituted for "section" to reflect the PFIC provisions as enacted.

Comments of Citicorp
on the Technical Corrections Act of 1987, S. 1350
Submitted to the Committee on Finance
United States Senate
July 24, 1987

Citicorp wishes to thank the Committee for giving it the opportunity to comment upon S. 1350, the Technical Corrections Act of 1987, and to suggest additions thereto. These comments and suggestions are summarized below.

- Citicorp recommends that the reporting requirements imposed on a real estate mortgage investment conduit be made as simple as possible as well as prospective in application. (Page 1)

- Citicorp recommends that any U.S. member of a group controlled by a bank holding company be deemed to have satisfied the predominantly engaged test for purposes of the financial services income separate limitation. (Page 2)

- Citicorp recommends that the Act be amended to fix a percentage of income attributable to financial services income above which an entity is deemed to be "predominantly engaged." Page 3)

- Citicorp recommends that the statute be amended to clarify that expenses are to be allocated at the U.S. recipient level under current Treasury Regulations Section 1.861-8 rules. (Page 4)

- Citicorp recommends that the bill be modified to allow banks to receive export financing interest and treat it as financial services income, without regard to whether such interest is subject to a high withholding tax. (Page 5)

- Citicorp recommends that accumulated deficits in earnings and profits attributable to taxable years of a controlled-foreign corporation beginning before 1987 be eligible to reduce Subpart F income in taxable years after 1987. (Page 7)

- Citicorp recommends that, in determining the functional currency of a qualified business unit, the taxpayer should be allowed to use the same functional currency for the qualified business unit as is used for such taxpayer's U.S. financial accounting reporting purposes. (Page 8)

- Citicorp recommends that the term "foreign income taxes" be amended to include "in lieu of taxes." (Page 9)

- Citicorp recommends that a taxable mortgage pool be treated as a separate corporation for all purposes under the Internal Revenue Code. (Page 10)

REMIC Reporting

Statutory Provisions

Code Sections 860A-860G; Act Sections 671-675

A new entity, called a REMIC, has been created which will hold a fixed pool of real estate mortgages and issue multiple classes of interests to investors designated as regular or residual interests. In general, the REMIC, like the partnership, will not be treated as a separate taxable entity, but instead its income will be passed through to investors. The REMIC will also have information reporting responsibilities to the holders of interests with regard to interest and OID.

Issue Presented

The Conference Report indicates (page II-237) that the REMIC will also have reporting responsibilities for accruals of market discount and amortization of premium in accordance with provisions of the conference agreement. Code Section 6049(d)(7) gives the IRS broad authority to create exemptions from reporting for various entities, and in general tells the IRS to promulgate regulations to carry out the reporting responsibilities. In addition, the Conference Report (page II-237 fn. 19), although stating that market discount and amortization reporting is to be carried out in accordance with provisions of Act Section 1803(a)(13), does not define exactly what provisions apply in the case of the REMIC. Code Section 860G also states in very general terms that the IRS shall promulgate regulations necessary to allow proper computation of taxable income of investors under the REMIC provision.

Recommendation

In view of the extreme complexity of the new REMIC provisions, reporting requirements imposed on a REMIC should be minimized and made as simple as possible to provide useful and intelligible information to investors and sufficient information to the IRS. Because interests in REMICs will be issued to investors prior to the promulgation of any regulations, all reporting obligations of the REMIC should be prospective to avoid unnecessary disruption in the markets for these interests. The statute should specify the reporting responsibilities and procedures of the REMIC under all applicable Code sections.

Statutory Provision

Code Section 904(d)(2)(C)(ii); Act Section 1201(b)

If an entity is predominantly engaged in the active conduct of a banking business, the separate limitation for financial services income will apply to any passive income earned by the entity in that year as well as to financial services income.

Issue Presented

Under the Conference Report (page II-571), the predominantly engaged test is deemed to have been satisfied if, in cases involving the separate limitation look-through rules, either the U.S. income recipient or the related payor of the income independently satisfies the test. It is unclear whether this test will also be met where both the U.S. income recipient and the payor are not predominantly engaged in the active conduct of a banking business, but the U.S. income recipient is a member of a group controlled by a bank holding company.

Recommendation

The statute shuld be amended to specify that a U.S. member of a group controlled by a bank holding company is deemed to have satisfied the predominantly engaged test for purposes of the separate limitation for financial services income. This rule should apply regardless of whether the U.S. member (income recipient) or the payor have independently satisfied the predominantly engaged test. Justification for this result is based upon the fact that a bank holding company and the members it controls are highly regulated banking groups whose predominant activity must be banking or finance. As part of an integrated and regulated controlled group, a U.S. member should be deemed to be predominantly engaged in the same business as that of the bank holding company which controls it.

Foreign Tax Credit Limitations

Statutory Provision

Code Section 904(d)(2)(C)(ii); Act Sectión 1201(b)

The term "financial services income" includes what would otherwise be passive income if the entity which derives such income is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. Act Section 1201(b)(2)(C)(ii) and Code Section 904(d)(2)(C)(ii). This special tax rule is the counterpart to the banking exception in the Subpart F provisions under prior law. Its purpose is to permit an entity to treat certain passive types of income such as dividends and interest as active income if it is earned while the entity is predominantly engaged in a banking or financing activity.

Issues Presented

The Conference Report does not specify how high a percentage the entity's income must be attributable to financial service activities or what specific activities, if any, the entity must perform in order for it to be considered predominantly engaged in the active conduct of a banking, insurance, financing or similar business. Instead, it is left to the discretion of the Secretary to promulgate regulations for such a determination.

The Conference Report (page II-571) states that an entity which satisfies the predominantly engaged test may earn income that is integrally related to its banking, insuring, or financing activity. Such income is to be treated as financial services income even though it would not otherwise be classified as such. An example cited is income from equipment leasing. It is not clear from the preceding whether a foreign leasing facility (subsidiary) will meet the predominantly engaged test if its leasing income constitutes its primary source of income. Nor is it clear that providing financial information will qualify as a financial service activity.

Recommendations

The statute should be amended to fix a percentage of income attributable to financial service activities above which an entity is considered to be "predominantly engaged".

Equipment leasing and the prcvision of financial information services should qualify as financial activities. In the case of leasing, the income earned therefrom should be considered financial services income even if, under financial lease terms, such income is to be treated as equivalent to interest.

Statutory Provision

Code Section 904(d)(2)(F); Act Section 1201(b)

Under the new high-tax kick-out rule, passive income is excluded from the separate limitation for passive income and put into the overall limitation when the foreign tax paid with respect to that income exceeds the highest U.S. tax rate multiplied by the amount of that income after allocation of parent expense. Act Section 1201(b)(2)(F) and Code Section 904(d)(2)(F).

Issue Presented

The Conference Report does not specify whether U.S. or foreign tax concepts should apply in determining whether a particular item of income is high-taxed. What method of allocating the expenses of the parent against the passive income of the subsidiary should be used?

Where the foreign income is subject to tax under a single tax base or different bases than the U.S. tax base, rules are needed to allocate those taxes between items of income. For example, how are foreign taxes paid by a foreign corporation allocated between passive and active income when the foreign country has different timing, characterization, and deduction rules? The Conference Report does not explain how the amount of foreign income tax paid with respect to a particular item of tax is to be determined. Finally, the issue of when an item of income is to be treated as high-taxed is not addressed. For example, is the income treated as high-taxed where it is not high-taxed when accrued but is high taxed when distributed in a subsequent year (e.g., a foreign subsidiary is on a cash basis for local tax purposes, while the U.S. parent is on the accrual basis)?

Recommendations

The statute should be amended to clarify that expenses are to be allocated at the U.S. recipient level under current Treasury Regulations Section 1.861-8 rules. It should also address the issue of determining when an item of FPHC income is deemed to be high-taxed. The appropriate date of determination should correspond to the date of U.S. income inclusion or deemed inclusion (e.g., a subpart F inclusion). To the extent that the foreign tax rate differs when the income is subsequently distributed (as income previously taxed under Subpart F), an adjustment in the tax liability should be made. This approach is consistent with present law's special rules for determining foreign tax credits with respect to earnings and profits previously taxed under Subpart F. See Code Section 960(b).

Export Financing Interest Exception

Statutory Provision

Code Section 904(d)(2)(G); Act Section 1201(b)

H.R. 2636, Section 112

New Code Section 904(d)(2)(G) defines export financing interest as that received by a taxpayer or a related party engaged in manufacturing, producing, growing, or extracting certain U.S. exports. Under Code Section 904(d)(2) generally, export financing interest is excluded from the separate limitations for passive, high withholding tax, and shipping income. The bill provides that export financing interest is financial services income if it is received by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, if such income is subject to a high withholding tax. Otherwise, such interest is treated as overall limitation income.

Issues

The Conference Report (page II-565) includes an export financing interest "exception" to minimize the risk that tax reform legislation will reduce the availability of export financing and thus negatively impact the volume of U.S. exports. This is accomplished by exempting export financing income from the new separate limitations created by Code Section 904(d)(2) and treating it as overall limitation income with one exception. In addition, if received by a bank, export financing interest is not subject to the repeal of banking income deferral under Subpart F. Code Section 954(c)(3)(B).

Notwithstanding the Conferees' intention under the definition of "export financing interest", <u>banks are ineligible to receive export financing interest because they are prohibited under U.S. banking laws from conducting non-banking activities such as manufacturing, producing, growing, or extracting goods for export and are prohibited from being a related party to such activities.</u> The export financing exception, therefore, excludes banks which can neither be the eligible taxpayer nor a related person under Code Section 904(d)(2)(G).

The new Subpart F rules of Code Section 954(c)(2)(B) also provide that export financing interest received by banks is not foreign personal holding company income. This preserves in part the previous law bank income exception to the Subpart F rules [old Code Section 954(c)(3)(B)], the remainder of which is repealed. Code Section 954(c)(2). The preservation of the deferral, however, when coupled with the limitation on entities eligible to receive export financing interest under Code Section 904(d)(2)(G), is not available to any U.S. bank barred from receiving export financing interest (because it is either not engaged in manufacturing, etc., or it is not a party related to any manufacturer, etc.).

The bill also requires that export financing interest be subject to a high withholding tax in order to be treated as financial services income by a banking, insurance, finance, or similar company. If such interest is subject to a gross basis tax of less than five percent, even if received by an entity predominantly engaged in banking, etc., it is overall limitation income. The bill explanation states that this will allow manufacturers and the other listed eligible recipients of export financing interest to cross-credit low taxed export financing interest against other higher taxed overall limitation income. Thus, even if banks were eligible to receive such interest, placing it in the overall limitation (where banks have no other income) results in a loss of the benefits of such income and the foreign taxes paid thereon.

Recommendations

Code Section 904(d)(2)(G) should be amended to effectuate the Conference Report statements and the preservation of the Subpart F deferral rules to remove the requirement that such interest be received by a taxpayer or a related person engaged in manufacturing, etc. The removal of the "engaged in . . . manufacturing", etc., and the "related party" requirements would comport with the U.S. banking laws and would thus allow U.S. banks and their foreign subsidiaries to be eligible to receive export financing interest income.

The bill should be amended to exclude the requirement that export financing interest be subject to a high withholding tax in order to be treated as financial services income where that interest is received by an entity predominantly engaged in the active conduct of a banking business.

Statutory Provision

Code Section 952(c)(1)(B); Act Section 1221(f)

For taxable years beginning after December 31, 1986 accumulated deficits in earnings and profits can reduce current earnings and profits of a CFC only if the deficit is attributable to certain qualified activities and only to the extent of current earnings and profits from the corresponding qualified activity. Only accumulated deficits for taxable years beginning after December 31, 1986 may be carried forward to reduce subpart F income.

Issue Presented

The Conference Agreement states several reasons for the limitation on the use of accumulated deficits to reduce subpart F income, including making the subpart F rules consistent with the changes in the foreign tax credit separate limitation rules and preventing taxpayers from sheltering passive investment income from U.S. taxation by moving those investments into CFC's with prior years deficits. No explanation is given however, for eliminating the use of accumulated deficits incurred in taxable years prior to January 1, 1987.

Recommendation

The rule that accumulated deficits in earnings and profits attributable to taxable years of the CFC beginning before 1987 may not be carried forward and used to reduce subpart F income in taxable years after 1987 is unduly harsh. Pre-1987 deficits in earnings and profits which the taxpayer can establish to the satisfaction of the Secretary are attributable to activities that under current law would have been treated as qualified activities should be permitted to be carried forward in the same manner as post-1986 deficits attributable to qualified activities.

Statutory Provision

Code Section 985; Act Section 1261

All determinations under the Internal Revenue Code of 1986 must be made in the taxpayer's functional currency. In the case of a qualified business unit, the functional currency is determined, in essence, pursuant to a facts and circumstances test.

Issues Presented

What rules should be applied to determine what constitutes the functional currency of a qualified business unit?

Under certain circumstances to be set forth in regulations, a taxpayer may elect the U.S. dollar as the functional currency of a qualified business unit. The Conference Report (page II-661) indicates that such election may be conditioned on the taxpayer electing the U.S. dollar as the functional currency of all of its qualified business units. Is this rule warranted?

The Conference Report (page II-659), referring to the Senate Amendment, indicates that pending issuance of regulations, original issue discount on nonfunctional currency denominated obligations will be determined in terms of units of the nonfunctional currency and translated into the functional currency using the average exchange rate for the accrual period. Is this approach reasonable?

Recommendations

Since rules similar to those prescribed in FASB 52 were intended to apply in determining the functional currency of a qualified business unit, a taxpayer should, as a safe-harbor, be allowed to use the same functional currency of a qualified business unit for income tax purposes as is used for such taxpayer's U.S. financial accounting reporting purposes. Clarification of this issue is extremely important not only for purposes of determining the taxable income and earnings and profits of a qualified business unit, but also for purposes of determining the tax consequences attributable to various transactions entered into by a qualified business unit (e.g., interest rate conversion agreements).

Inclusion of In Lieu Of Taxes

Statutory Provision

Code Section 986; Act Section 1261

Code Section 986 provides rules to determine the U.S. dollar amount of foreign income taxes paid by a foreign corporation for purposes of Code Sections 902 and 960. The term "foreign income taxes" as defined in Code Section 986(b)(2) does not currently include Code Section 903 "in lieu of" taxes.

Issue Presented

Should "in lieu of taxes" be included in the definition of foreign income taxes under Code Section 986(b)(2)?

Recommendation

Code Section 903 or Code Section 986(b)(2) should be amended to provide that for purposes of subpart J the term "income, war profits or excess profits taxes" shall include a tax paid in lieu of such taxes otherwise generally imposed by any foreign country or by any possession of the United States.

Treatment of Taxable Mortgage Pools

Statutory Provision

Code Section 7701(i); Act Section 673

Code Section 7701(i)(2) defines a taxable mortgage pool (TMP) as any entity, other than a REMIC, if (1) substantially all the assets consist of debt obligations, and more than 50% of the obligations consist of real estate mortgages; (2) the entity is the obligor on debt obligations with 2 or more maturities; and (3) under the terms of the debt obligations on which the entity is obligor, payment made by the TMP bears a relationship to payments by underlying obligors on debt obligations held by the TMP. Code Section 7701(i)(2)(b) states that any portion of an entity meeting this definition is treated as a TMP. Code Section 7701(i)(1) states that a TMP shall be treated as a separate corporation which may not be treated as an includible corporation with any other corporation for purposes of Code Section 1501.

Issue Presented

The Conference Report (page II-239) confirms that a REMIC is to be the exclusive means of issuing multiple classes of real estate mortgage-backed securities without two-levels of taxation, and that a TMP is to be treated as a separate corporation not includible in a consolidated return. It is not clear, however, whether a TMP is to be treated as a separate corporation for <u>all purposes</u> under the Internal Revenue Code.

Recommendation

Code Section 7701(i)(1) should be amended to state that a TMP is to be treated as a separate corporation for all purposes under the Internal Revenue Code. Treating a TMP as a separate corporation for all purposes of the Code has the benefit of providing a single, consistent set of rules for the treatment of TMPs.

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COMMENTS BY COALITION OF INSURERS OF NON-PROFIT HOSPITALS TO THE COMMITTEE ON FINANCE ON THE TECHNICAL CORRECTIONS ACT OF 1987

1. Background

The Tax Reform Act of 1986 revised the taxation of property-casualty insurance companies. The principal impact of the changes came through discounting of loss reserves for federal income tax purposes, even though companies continued to carry full value reserves for state regulatory purposes. This provision, which is estimated to generate $4.2 billion in tax revenues over 5 years, falls principally upon the lines of business requiring the longest time to settle claims--medical malpractice, general liability, and worker's compensation. For these "long-tail" lines, the difference between the discounted reserve deduction for federal income tax purposes and the full value reserve established for state regulatory accounting purposes, is substantial. For non-profit hospital medical malpractice coverage written by coalition members, the estimated discount based on the industry aggregates adopted by the Treasury in Rev. Rul. 87-34 amounts to 24% of the increase in their reserves. Accordingly, for this group of insurers the amount of the deduction allowed for increases in loss reserves has been reduced on average by approximately 24%.

2. Insurers of Non-Profit Hospitals Severely Impacted by New Law

There are 31 insurance companies, subject to the Act, which are either hospital-owned or hospital-sponsored which provide medical malpractice coverage for primarily non-profit hospitals. These companies are organized in various forms including trusts, tax-exempt associations, or as taxable corporations. These companies were formed by hospitals to provide their malpractice and general liability coverage were begun after the medical malpractice crisis of 1975, and include two companies recently formed as a result of the liability crisis of 1985-86. They were formed primarily to assure the availability of malpractice insurance to hospitals at the lowest reasonable cost.

The companies are organized primarily as stock insurance companies with insured hospitals or hospital trade associations as their shareholders. They include reinsurers as well as primary insurers; mutuals and reciprocal insurers in a few instances; and their insureds include a very small number of for-profit hospitals, as well. These 31 hospital owned or sponsored companies now provide approximately 70% of the malpractice coverage for non-profit hospitals in this country.

Insurers of non-profit hospitals are especially hard-hit by the new discounting provisions. The coverage they provide to hospitals is predominately the lines most affected by discounting--medical malpractice, and, smaller amounts of general liability. According to a survey of these companies, they expect to pay an additional $46.5 million in taxes on reserves of $1.8 billion for 1987, despite the fresh start adjustment. Over a 5 year period, assuming a 12.5% rate of growth for 1988 and later years, the additional tax attributable to discounting would amount to more than $137.6 million. The calculation of these additional taxes is illustrated in the chart on the following page.

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CHART A

Estimated Revenue Effect of Loss Discounting Rules
(based on survey estimates of 31% growth of loss reserve
for 1987 and projected 12.5% rate of annual growth
of loss reserves thereafter)

(all figures in thousands of dollars)

	1987	1988	1989	1990	1991
Estimated loss reserve @ year end	1,834,911	2,064,275	2,322,309	2,612,598	2,939,173
Discounted reserves (@ 76%)	1,389,504	1,563,192	1,758,591	1,978,415	2,225,717
Loss reserve discount	445,407	501,083	563,718	634,183	713,456
Less prior year loss reserve discount (including fresh start)	329,223	445,407	501,083	563,718	634,183
Increase in taxable income	116,184	55,676	62,635	70,465	79,273
Tax rate	40%	34%	34%	34%	34%
Tax effect	46,473	18,930	21,296	23,958	26,953

3. Non-Profit Hospital Insurers Must Increase Premiums Dramatically to Pay the Additional Taxes

Unlike large multi-line commercial insurers, which monitored the tax proposals closely and lobbied actively during Congressional consideration of the new provisions, these smaller companies did not appreciate the new law's impact until they reviewed their estimated tax projections this spring. They do not have substantial net operating loss carryforwards to shelter their taxable income during the Act's initial years, as do many multi-line commercial carriers. The substantial additional costs imposed by the new tax law must be passed along to the hospitals with a minimum of delay. These companies, writing medical malpractice insurance for primarily non-profit hospitals, are on the horns of a dilemma of either dramatic rate increases or substantial reductions of coverage--neither of these is acceptable to the non-profit hospitals which are their stockholders and insureds.

4. The Harsh Impact of The New Law Should Be Modified

These companies are willing to pay their fair share of taxes. The burden of the 1986 changes, however, falls disproportionately on long-tail lines. It is not spread evenly across all property-casualty insurers. For example, for one of these companies, MMI Companies, Inc. of Bannockburn, Illinois, the changes in the Act could result in estimated 1987 federal income tax liability of $5.6 million on estimated statutory consolidated net income of $6.9 million. That result could occur despite the use of a $7.7 million NOL carryforward in 1987. This 81% tax rate in 1987 is confiscatory and inconsistent with established tax policy.

Daniel J. McNamara, President of the Insurance Services Office ("ISO"), a not-for-profit service organization that provides advisory rating, research, and statistical information to property-casualty insurers, commented on the concentration of the tax burden on long-tail lines in an address this January:

> While the impact of the new tax law may be small for all lines combined, a new ISO study indicates that the impact is large for each of three long-tail commercial casualty lines of insurance that we analyzed--general liability, workers compensation, and medical malpractice.
>
> Our study focused on the first-year impact of the Tax Reform Act, and compared the bottom-line results under the new and old tax laws against various scenarios of underwriting results. The results of our study are sobering.
>
> For general liability insurance, we studied scenarios based on 1987 combined ratios [a standard industry measurement of all premium income to all expenses] ranging from 100 to 120. Our conclusion -- the combined ratios under the new tax law must be six to eleven points lower than required under the old tax law to produce the same after-tax earnings for this line of insurance. The higher the combined ratio, the greater the impact of the new legislation. . .

For medical malpractice insurance, we studied an ever wider range of combined ratios--115 to 155. Under the new tax law, the combined ratio must be twelve to twenty-two points lower to produce the same after tax earnings as before.

Because of our study's sobering results, ISO subjected its methodology, quantitative analysis, assumptions and conclusions to independent outside review by Coopers & Lybrand. The tax and actuarial partners of that organization have confirmed that validity of our methodology and analysis and concur in the reasonableness of our assumptions as well as results.

Speech before the Annual Meeting, January 13, 1987.

5. Proposed Modification: Delay Imposition of the Discounting Rules for 2 Years

The intent of Congress in revising the property-casualty insurance provisions was to ensure that commercial carriers, which had historically paid a very low rate of tax, assumed their fair share of taxes. The impact of discounting, however, was not fully appreciated when the Act was passed. Revenues are not being raised equally from all companies and their policyholders. Unfortunately, the effect of the Act varies widely depending upon the lines of business written. The disproportionate impact of the new provisions upon long-tail lines has meant that non-profit hospitals, which formed these specialized insurers to guarantee that coverage would be available and affordable, now face dramatic rate increases or reductions of coverage.

To prevent unanticipated increases in medical malpractice insurance, and to allow Congress to fully assess the impact of the new law on insurers and policyholders, particularly non-profit hospitals, we request that the specialized insurers providing medical malpractice and other coverage to non-profit hospitals be granted a two-year delay in imposition of the discounting rules of the 1986 Act. This deferral will prevent non-profit hospitals from bearing a disproportionate share of the costs associated with restructuring the taxation of property-casualty insurers. This will also allow these specialized insurers to submit material to the Treasury Department for consideration in its study of the loss reserve discounting rules due in January, 1989.

6. Revenue Impact

We estimate that these 31 companies will hold approximately $1.8 billion in reserves for 1987. A two year delay, according to our best estimates, would result in a revenue loss of $46.3 million in 1987, and $18.9 million in 1988, or a total of $65.4 million for the two years. (see Chart B)

Given the pressures on all hospitals to reduce costs, we believe this deferral is a sensible means to alleviate the unanticipated and unintended harsh impact of the Act upon non-profit hospital insurers.

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CHART B

REVENUE EFFECT OF TWO-YEAR DELAY TO JANUARY 1, 1989 IN EFFECTIVE DATE OF LOSS DISCOUNTING RULES WITH CHANGE OF FRESH START DATE TO DECEMBER 31, 1988
(all dollar amounts in thousands)

Note: The following projections incorporate the total revenue effect for hospital-formed companies writing medical malpractice insurance for primarily non-profit hospitals. The estimated revenue loss drops between 1987 and 1988 because of the reduction of the corporate tax rate from 40% to 34%, and a slower projected rate of growth of loss reserves.

		12.5% growth assumption
Estimated revenue effect	1987	($46,473)
	1988	(18,930)
	1989	--
	1990	--
	1991	--
	Total for period	($65,403)

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Amendment to Technical Corrections Act
for Non-Profit Hospital Insurers

1. Background: The Tax Reform Act of 1986 revised the taxation of property-casualty insurers. The largest single change occurred in discounting the loss reserves of insurers for federal income tax purposes, an item expected to produce $4.2 billion of revenue over a 5 year period.

2. Impact of Discounting Falls Primarily on Long-Tail Lines Such as Medical Malpractice: The intent of Congress in revising the property-casualty insurance provisions was to ensure that commercial carriers, which had historically paid a very low rate of tax, assumed their fair share of taxes. The impact of discounting, however, on certain important smaller companies which sell only a few lines of long-tail insurance was not fully appreciated when the Act was passed. Revenues are not being raised equally from all companies. The effect of the Act varies widely depending upon the lines of business written, severely impacting companies which write exclusively long-tail lines.

3. Insurers of Non-Profit Hospitals Must Increase Premiums Dramatically to Pay the Additional Taxes: Unlike large commercial insurers, which had the resources to monitor the tax proposals closely and lobbied actively during Congress's considerations of the new provisions, these smaller companies did not appreciate the new law's impact until they reviewed their estimated tax projections this spring. They do not have substantial net operating loss carryforwards to shelter their taxable income during the Act's initial years, as do many commercial carriers. Unlike multi-line insurers, they cannot spread the new taxes across all lines of business equally. The additional taxes must be passed along to the hospitals without delay.

4. The Harsh Impact of the Law Should Be Modified: To prevent unanticipated increases in medical malpractice insurance for non-profit hospitals, we request that the specialized insurers providing medical malpractice and other coverage to non-profit hospitals should be granted a two-year delay in imposition of the discounting rules of the '86 Act. This deferral will prevent non-profit hospitals from bearing a disproportionate share of the costs associated with restructuring the taxation of property-casualty insurers.

5. Revenue Impact: We estimated that the 31 companies which were hospital owned or sponsored and provided medical malpractice coverage for primarily non-profit hospitals will hold approximately $1.8 billion in reserves for 1987. A two year delay would result in a revenue loss of $46.3 million in 1987, and $18.9 million in 1988, or a total of $65.4 million for the two years.

COMMENTS ON THE COUNCIL OF
INDUSTRIAL DEVELOPMENT BOND ISSUERS
ON THE
"TECHNICAL CORRECTIONS ACT OF 1987"

On behalf of the Council of Industrial Development Bond Issuers (CIDBI), I am writing to provide comments on the "Technical Corrections Act of 1987," S. 1350. I would also like to share additional concerns of Council members pertaining to the Tax Reform Act's effects on qualified small issue bonds.

These comments are based on specific issues raised by our membership at our recent conference and post-Act surveys of our membership. CIDBI is an organization of more than 140 public agencies of state and local governments that was formed to promote the continued and effective use of small issue industrial development bonds.

First, CIDBI supports the bill's provisions to further clarify the intent of Congress regarding the refundings of qualified small issue bonds for non-manufacturing facilities. As you know, authority to use small issue bonds for non-manufacturing projects terminated December 31, 1986. As a result of what some perceived as an inconsistency in the 1986 Act provisions, refundings of this previously-eligible category have been made more difficult and in some cases postponed due to uncertainty about applicable provisions of the Code.

The provisions of S. 1350 and the Treasury Department's statement should correct any problems associated with such refundings. CIDBI supports the proposed changes and commends the bill's sponsors for taking action to remedy this problem.

Let me note several related issues on refundings. On March 3, the Internal Revenue Service issued a revenue ruling (Rev. Ruling 87-19) disallowing a waiver of the right of bondholders to receive a higher rate of interest if the terms of the bond require such rate adjustments. To do otherwise, according to the IRS ruling, would be deemed an exchange and thus would be considered a reissuance. In view of the legislative uncertainty that often encouraged such rate adjustment provisions in bonds, this seems to be a relatively harsh regulatory reaction given other features of the 1986 Tax Reform Act.

The issue here is the July 1 effective date of the corporate income tax reduction and the associated interest rate hikes that bondholders must impose if so called "gross-up" or other adjustment provisions require it. In almost all cases, the issues are pre-1986 Tax Reform small issue industrial development bonds. The bondholders are predominantly financial institutions. As a result of the IRS ruling, refundings, normally a function of interest rate changes, are in many cases being driven primarily by the July 1 effective date of the corporate income tax rate reduction. Small issue bond borrowers seeking refundings to escape these seemingly artifical adjustments have been frustrated not only by the new 1986 Code requirements related to non-manufacturing projects, but also by Section 265 of the 1986 Code which would deny financial institutions an interest deduction for their expense of purchasing and carrying such tax-exempt bonds. This is a rather "Catch 22" result where Rev. Ruling 87-19 almost compels a refunding, and the financial institution under Section 265 is almost compelled not to purchase the refunding bonds. Certainly, this was not intended.

Thus such small issue bond refundings are driven by date certain interest rate hikes and also have to overcome a significant market impediment. That impediment is the denial under Section 265(b) of the interest deduction for the refunding issue which is Rev. Ruling 87-19 driven. Banks are no longer purchasing such bonds in any significant amount or number. As a result, borrowers relying on either new and refunding bonds must enter markets dominated by purchasers unfamilar with the borrowers and the small issue bond program generally. In some areas, the market has not responded efficiently and there are few, if any, opportunities to seek alternatives to the automatic "gross-up" of interest rates on prior issues.

The key point to be made is that even with the clear refunding authority, such bonds have to seek an entirely new market as a result of the denial of interest expense deductions under Section 265(b) of the new Code.

I would also like to take this opportunity to share with the Committee several issues of concern that may go beyond the Chairman's announced intentions to consider only technical corrections. I would hope the Committee will consider these issues at the appropriate time so that new qualified small issue bonds can more effectively be used to further important national economic development objectives.

First, I would urge the Committee to clarify and correct the "manufacturing facility" definition, and the surprisingly restrictive interpretation that surfaced for the first time in the "blue book" for the Tax Act of 1984. Now that definition, as a result of the 1986 Tax Act, has been frustrating projects since January 1, 1987.

CIDBI's post-1986 Tax Act survey, conducted during the first quarter of 1987, demonstrated significant problems in practical application of small issue bond authority due mainly to the manufacturing facility definition. Issuers and bond counsel have had difficulty in making the very basic determinations of project eligibility for certain facilities.

For issuers, knowing more readily what projects are eligible would help overcome an initial impediment for borrowers and could eliminate unneeded legal costs, particularly for smaller businesses. Additionally, a clarifying amendment would help agencies focus on the more difficult task of accessing the market.

The loss of banks in the market has compelled issuers to seek pooled financings in order to both lower costs for borrowers and to access new markets. Such markets are generally public. To undertake pooled or composite issues, certain and quick determinations of eligibility are essential. Assembling a pool of borrowers as part of a single pooled issue, on the same schedule, is difficult enough. As you know, the tax-exempt status of the entire pool is tied to the tax-exempt eligibility of each of the individual projects. Clear issuing authority is of critical importance to potential purchasers of these pooled financings and for compliance with provisions of the Act, especially in public markets.

CIDBI urges the Committee to consider, for example, using the Standard Industrial Classifications (SIC) for "manufacturing" to clarify the current definition. Since the IRS is not expected to issue timely regulations on the current definition, the use of SIC codes for manufacturing would certainly facilitate issuers' efforts and subsequent actions by IRS to make individual determinations as well.

The Council also urges the Committee to provide clarification of the existing manufacturing definition for eligibility for small issue bond financing. There are several key reasons for this recommendation:

- o State and local governments need more flexibility to facilitate investments in direct manufacturing projects and related manufacturing facilities. More clear authority would help issuers further federal objectives to promote capital formation and competitiveness in the broader manufacturing sector.

- o The existing definition, which was given a surprisingly restrictive interpretation in the "blue book" explanation of the 1984 Act, has not been updated to reflect present needs of manufacturing firms and related activities.

- o Finally, the survival and competitiveness of manufacturing firms is no longer simply tied to purely manufacturing activities, and Congress in its recent actions has underscored the importance of related activities, such as research and development.

CIDBI is ready to provide specific recommendations to the Committee concerning the basis for a more workable "manufacturing facility" definition.

Finally, because of volume limits on the issuance of private activity bonds, modification of the definition could not increase any projected federal revenue losses. In addition, based on our review of the state bond volume limitations and expected demand, bond issuance during 1987 will occur at levels below that assumed by the Committee during last year's debate. This underutilization, due to a number of factors, will reduce assumed tax expenditures in 1987, yielding savings which will be compounded over the next several years. An amendment to the "manufacturing facility" definition could be enacted consistent with the stated committee concerns about not adding amendments to S. 1350 which would cause any further loss of revenue.

The effects of the Act on the market for small issue bonds are dramatic. The elimination of the interest expense deduction for banks under Section 265(b) for purchases of qualified small issue bonds has been devastating on the market for this category of tax-exempt bonds. Very few issuers have yet even issued a single small issue bond during 1987.

According to CIDBI's national study of the program, released in January 1986, banks accounted for nearly 90% of all small issue bond purchases. This traditional market, dominated by local banks, passed through the benefits of the 80% interest deduction directly to the borrowers through lowered interest rates. For borrowers, the denial to banks of the interest expense deduction under Section 265(b) translates into higher borrowing costs. This is especially true for small businesses and manufacturing firms that require special incentives and for borrowers generally. In many cases, qualified small issue bonds financing often determines whether or not some of these targeted projects move forward.

The effective unavailability of qualified small issue bond financing has essentially done away with almost all smaller community economic development programs. The money markets simply do not respond well to $500,000 - $1,000,000 project financings. Local banks often do.

We would also note that the inability of banks to deduct the interest expenses of purchasing and carrying private activity bonds is in many cases based on a false premise. Most small issue bonds are the result of banks extensively working with the borrowers, devising and assisting with financial and business plans, especially as to smaller projects. These are issues where banks perform "due diligence," extensive loan review, and provide other related services. These banks do not rely on securities laws for protection. They are not buying in a market like individuals do. In these cases of extensive bank involvement in the analysis of the credit and the project, the banks have earned the right to deduct for their purchasing and carrying costs of such bonds. In the case of such extensive bank involvement with the borrower and project, the comparison to individuals inability to deduct such purchase and carrying costs is inappropriate. After all, individuals generally are buying in recognized markets and realize more of the protections of securities laws. Somehow this analysis did not enter into the debate on the 1986 Act.

The loss of the interest expense deduction for banks under Section 265(b), combined with other new limitations, has disproportionately affected smaller borrowers and others most in need of affordable capital. CIDBI, since its inception, has been working with its member agencies to target small issue bonds increasingly toward smaller businesses, a category of borrower which can yield real opportunities for new job creation and other real benefits for the nation. This emphasis on smaller businesses also complemented Congress' earlier efforts, as provided for in the 1982 and 1984 Acts, to limit eligibility to smaller firms as well. Under the array of new rules under the 1986 Tax Act affecting small issue bonds, this emphasis on smaller issues is not possible.

The initial effects of the market-related provisions of the 1986 Act have resulted in squeezing the smaller projects out of the small issue program. Now small issue bonds to assist these businesses must be brought to the public markets. The cost of credit enhancement and other transaction costs are such that issues of less than $2 million, at the top range, cannot be sold individually. The public markets generally are not responsive to these smaller issues. Such smaller financings can move forward as part of pooled programs, but generally issues of less than $1 million are still not viable.

CIDBI and its members are working to create alternative and innovative programs to respond to the market-related provisions of the Act. There are several successful programs that indicate the market will adjust. However, for certain smaller borrowers and in certain areas of the country, it is not likely that the Act's unintended bias against smaller borrowers and issues can be offset in the immediate future, if at all.

I would like to note our concerns about the state bond volume limitations. In the immediate post-1986 Act environment, all bond activity has slowed to the point that the full effects of the volume cap have been dramatically understated. Small issue bonds have slowed reflecting the loss of the bank market and the counter-cyclical nature of the program. In the early 1980's, particularly, it helped ensure that economic activity, that would not have occurred otherwise, could go forward. During that cycle, the program really helped businesses, particularly smaller ones that were shut out of the market, to borrow capital and undertake projects vital to the business, its community and the nation's economy.

Finally, CIDBI urges the Committee to reconsider the Dec. 31, 1989 small issue bond sunset at the appropriate time in light of the significant public benefits of the program as a tool to promote small business development, stimulate capital formation, to help lower trade deficits, and further competitiveness of the nation's businesses.

CIDBI appreciates the opportunity to share these concerns with the Committee and we look forward to working with the Committee on technical corrections and other legislation.

Committee of Banking Institutions on Taxation

ESTABLISHED 1918

This Committee consists of National and State Banks, Trust Companies, Private Banking Institutions and Agencies of Foreign Bankers. The members of its executive committee and its officers are selected from representatives of these institutions. Its objects are (a) to cooperate in assisting in the administration of tax laws; (b) to disseminate among its members information pertaining thereto; and (c) to act as a clearing house for communications to or instructions from Federal and State tax Authorities.

TECHNICAL CORRECTIONS BILL OF 1987

I. Application of 2% Floor to Trusts and Estates (Sections 101(f)(2), (3) and (4) of the Bill, Section 132 of the Reform Act, and Section 67 of the Code).

The Bill provides that the distribution deductions allowable to an estate or trust under Sections 651 and 661 of the Code are to be treated as allowable in computing the adjusted gross income of an estate or trust.

This provision creates a "Catch-22" situation in that you cannot compute the distribution deduction until you know the deductions allowable in calculating the entity's "Distributable Net Income" which would exclude the portion subject to the 2% floor. If you cannot compute your distribution deduction, you cannot compute the entity's "Adjusted Gross Income" and accordingly, the portion of the entity's deductions subject to the 2% floor.

Finally, under the provision, the Treasury has regulatory authority to apply the 2% floor at the beneficiary level, rather than at the entity level, to the extent that income is distributed to beneficiaries. This would be a meaningless allocation since net figures are advised out to beneficiaries and thus, under current law there is no provision for making the deductions subject to the 2% floor reportable by a beneficiary for regular income tax purposes.

II. Taxable Year of Common Trust Fund (Section 108(e)(5)(A) of the Bill and Section 584 of the Code)

A) The Bill provides that if a common trust fund is required to change taxable years, and as a result of such change a participant in such common trust fund is required to include items of income from more than one taxable year of the common trust fund in any of the participant's taxable years, the items of income from the short taxable year of the common trust fund may be included in income by the participant ratably over a four-taxable-year period.

The term "participant" needs clarification. Please note that technically the participant of a common trust fund is the trust or estate entity which has invested in the common trust fund and not its respective beneficiary. Since both the trust or estate and its respective beneficiary will experience "bunching of income" due to this mandated change to a calendar year, both should be accorded the option to report said income ratably over a four-taxable year period.

B) We strongly recommend that the statute should not be changed and that common trust funds be allowed to retain their current tax years.

Our arguments for a status quo are based on "hardship" rather than technicalities.

1. The processing of tax information for all trusts will be delayed a minimum of 30 days. This would be a result of having to first process the various funds so that figures could be fed into the participating accounts.

2. The delay in obtaining common trust fund tax information will make it more difficult to compute accurately and make timely payments of estimated taxes.

3. Providing beneficiaries with the required information (1041-K1) will be delayed accordingly (30 days plus) and result in more extensions of time to file.

4. Common trust funds are subject to an "outside" audit. Accounting firms will be hard pressed to satisfy this requirement since they will be faced with extremely heavy workloads immediately after year end.

5. Corporate fiduciaries already find their computer time at a premium at, and after, year end. This problem will be compounded.

If the status quo cannot be maintained, then in the spirit of addressing a supposed loophole without putting the undue hardships on corporate fiduciaries and respective beneficiaries in meeting with all tax administrative requirements that would stem from a mandated charge to a calendar year, we suggest the following alternatives.

1. Allow existing common trust funds to retain their current tax year and mandate that all new common trust funds, i.e. those created after December 31, 1986, adopt a calendar year; or

2. Mandating that all existing common trust funds adopt a tax year ending in September, October, November or December. The selection of any one of these fiscal years would involve minimal deferral.

III. Gifts of Appreciated Property - Items of Tax Preference. Section 107(c)(3) of the Technical Corrections to the Tax Reform Act of 1986, amendments related to title VII of the Reform Act, adds "or Section 642 (c)" to the reference already contained in Section 57(a)(6)(A) in Section 170.

The meaning of this addition is, at best, unclear. The purpose of the addition of Section 57(a)(6) to the 1986 Tax Reform Act was to capture as a preference item the untaxed appreciation on gifts to charity. However, this reference to the charitable contribution deduction allowable to estates and trusts overlooks a key difference between the manner in which charitable contribution deductions are allowable to estates and trusts and to individuals.

Individuals are entitled to a charitable contribution deduction under Section 170(c), and the charitable deduction for individuals of capital gain property is further limited by Section 170(b)(1)(c). However, while an individual is entitled to a charitable deduction for property given in kind to charity, the rules governing the charitable deductions of estates and trusts under Section 642 contain the basic distinction that charitable deductions are only allowed for amounts contributed to charity out of the estates or trusts "gross income" (see Section 642(c)(1) and (2)). An individual need not make a contribution out of income to generate such a deduction, and, as a result, treating the preference item created under Section 57(a)(6) accomplishes the desired legislative goal.

The expansion of this rule to cover the charitable contributions of estates and trusts is simply unnecessary. There is no charitable contributions deduction allowable to an estate or trust if the estate or trust does not first realize income (e.g., as a result of a sale, or of the receipt of an item of income such as a dividend) which is then, pursuant to the terms of the governing instrument, paid to (or, in the case of pre October 9, 1969 trusts, set aside for) charity.

It is recommended that this Technical Correction be deleted.

IV. Application of Capital Losses and Computation of Unused Carry-forward Losses. Sec. 301(b)(10) of the Reform Act amends Sec. 1211(b) of the Code and Sec. 301(b)(11) amends Sec. 1212(b)(2) Code.

The result of the above amendments is that a individual taxpayer (including estates and trusts) will be deemed to use up to $3,000. of a capital loss even if such taxpayer has no taxable income. Any carry-forward would be reduced accordingly.

We recommend that Sec. 1211(b) of the Code be amended to provide that, in the event of no taxable income, no loss would be allowable or deemed used, and the entire amount be carried forward under Sec. 1212(b)(2).

V. Annualization of a Trust's Taxable Income Re Mandated Converson From a Fiscal To A Calendar Year (Section 1403 of the Reform Act and Section 645 of the Code).

Under Section 443 of the Code, if a taxpayer's return is for a period of less than 12 months as a result of the taxpayer (with the approval of the Secretary) changing his annual accounting period, the taxable income for the short period shall be computed on an annualized basis.

Section 806 of the Reform Act which mandates the conversion to a calendar year re partnerships, S corporations, and personal service corporations, specifically states that "such change shall be treated as initiated by the taxpayer" (Section 806(e)(2)(A). Accordingly, Section 806(e)(2)(A) brings into play the requirements of Section 443 of the Code which mandates annualization of taxable income for the short taxable period.

In this regard, neither Section 1403 of the Reform Act (645 of the Code) nor the Technical Corrections Bill of 1987 contain language similar to Section 806 (e)(2)(A) of the Reform Act. Hence, one can properly conclude that the taxable income of a trust for its converted short calendar year does not have to be computed on an annualized basis since this change was not initiated by the taxpayer.

However, to make it clear that this was the intention of Congress, we suggest that the Technical Corrections Bill of 1987 amend Section 1403 of the Reform Act to indicate that Section 443 of the Code does not apply to this mandated conversion to a calendar year and further that the personal exemption be prorated.

If annualization is applicable, an inordinate amount of work would be created for trustees and the Internal Revenue Service. The following example illustrate the steps required under Section 443:

Assume a trust is currently on a January 31 fiscal year and the trustee (in accordance with the Act) adopts a calendar year. The short year ending December 31, 1987, contains 11 months (February 1 through December 31). Annualizing is accomplished as follows:

1. Determine taxable income, before exemptions, for the 11 months
2. Subtract 11/12 of the exemption (result is known as modified taxable income)
3. Multiply by 12
4. Divide result by the number of months in the short year (11)
5. Compute tax on amount from step 4
6. Multiply result by 11/12

The tax liability from step 6 would be remitted with the filing of the return on April 15, 1988.

The trustee must then wait until the original tax year is completed (January 31, 1988). He will then make the following two calculations.

A. compute the tax on the "modified taxable income" from step 2 above, and
B. compute the tax on the taxable income for the full 12 month period and multiply the result by

$$\frac{\text{modified taxable income for short period}}{\text{taxable income for entire year}}$$

If the larger of A or B exceeds the tax already paid, a claim for refund must be submitted for the excess.

The complexity of this entire exercise would be compounded by the alternative minimum tax, which would require another series of computations. Also bear in mind that these steps must be taken for each and every fiscal year trust.

COMMITTEE
FOR
FUTURE INVESTMENT
IN AMERICA'S PAST

William J. Wilkins, Esq.
Chief Counsel and Staff Director
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Re: Technical Corrections Act of 1987 (S. 1350)

Dear Bill:

The following comments are submitted by the Committee for Future Investment in America's Past (CFIAP), a coalition of private and public sector individuals and organizations active in rehabilitation and historic preservation, for consideration by the Committee on Finance with respect to S. 1350, the Technical Corrections Act of 1987. These comments, as described in more detail below, suggest technical corrections concerning the application of both the at-risk credit base rules to the rehabilitation tax credit and the passive activity limitations to investment in rehabilitated hotels.

1. Extension of At-Risk Credit Base Exception

A technical correction to section 46(c)(8) of the Internal Revenue Code (the "Code") should be made to conform the at-risk credit base rules provided for the low-income housing credit to those applicable to the rehabilitation credit.

Background

The Tax Reform Act of 1986 (Pub. L. No. 99-514) (the "Act") extended the at-risk credit base rules to real estate activities for the first time (section 503(a) of the Act; Code sections 465 and 46(c)(8)). Property that qualifies for the new low-income housing credit, however, is exempted from certain of the at-risk credit base rules including (1) the limitation on nonrecourse financing to 80 percent of the property's credit base, and (2) the requirement that financing be obtained from an unrelated party (although special limitations as to the lender do apply) (Code section 42(k)).

Problem

Like the low-income housing credit, the rehabilitation credit was provided by Congress to stimulate investment in projects that otherwise would not be funded. Congress recognized the significant risks and difficulties inherent in obtaining financing for low-income housing projects, and therefore provided exceptions from the new at-risk limitations for those projects. Rehabilitation projects are subject to the same types of financing obstacles as low-income housing projects. In fact, the rehabilitation credit is often used to create low-income rental housing. In certain cases, these two credits will be used in tandem (with appropriate basis adjustments as required by law.) In these cases it is particularly difficult to have to comply with two different versions of the at-risk rules for the same project.

Proposed Change

The at-risk rules for purposes of determining the rehabilitation credit base of rehabilitation property would apply in the same manner as they apply in determining the qualified basis of a building for low-income housing credit purposes.

A new subparagraph (G) should be added to section 46(c)(8) as follows:

> "(G) Special rule for certain rehabilitation property. --
>
> > (i) In general. -- Subparagraph(D) shall be applied to qualified rehabilitation property as if section 42(k) applied to such property.
> >
> > (ii) Qualified rehabilitation property.-- The term "qualified rehabilitation property" means property attributable to qualified rehabilitation expenditures determined under section 48(g)(2)."

2. Availability of Limited Exception from the Passive Loss Rules for Investment in Rehabilitated Hotels

A technical correction is necessary to correct a situation created by certain language contained in the Senate Finance Committee Report (S. Rep. No. 313, 99th Cong., 2d Sess. 743 (1986) (the "Report"); as restated in Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS-10-87, 217 and 249 (1987)) to provide clearly that tax credits arising from the rehabilitation of a hotel should qualify for the $7,000 exception to the passive loss and credit limitations.

Background

The Act contained a limited exception for rental real estate activities from the limitations on the use of losses and credits generated by "passive activities". Although all rental activity is deemed to be passive without regard to the extent of taxpayer participation (Code section 469(c)(2)), an individual taxpayer is allowed to offset nonpassive income and tax liability by up to $25,000 in losses and credit equivalents generated by rental real estate activity in which the individual "actively participates" (Code section 469(i)). Individual investors in rehabilitation tax credit rental projects can qualify for the rental real estate exception without meeting the active participation requirement.

The Report states, however, that the operation of a hotel is not a rental activity and, therefore, that a hotel is not a rental real estate undertaking (Report at 743). Thus, taxpayers investing in the rehabilitation of structures operated as hotels apparently are excluded from the $25,000 ($7,000 credit equivalent at the top bracket) exception regardless of the extent of their participation.

Problem

The Report language removes the rental activity "taint" from the operation of a hotel, protecting taxpayers involved in such activity from automatically being deemed engaged in a passive activity. See Report at 742. The language thus seems intended to protect taxpayers investing in hotels. The unavailability of the limited exception from the passive loss rules, however, may discourage and restrict investments in hotel rehabilitations.

It does not seem likely that Congress intended this language to limit credits for hotel rehabilitations. Indeed, since the special exception for the rehabilitation credit was not created until conference, the hotel language could not have been drafted with the intent of further limiting the rehabilitation credit exception. To deny investors in rehabilitated hotels eligibility for the exception on the grounds that the operation of a hotel is not rental activity, and therefore the rehabilitation of the hotel is not rental real estate activity, nullifies much of the utility of the exception. This could not have been what the conferees intended. Moreover, there is no policy reason to distinguish between a taxpayer who invests in the rehabilitation of a building that is leased to a hotel operator from one investing in the rehabilitation of a building leased as office space.

Proposed Change

Tax credits arising from the rehabilitation of a hotel should qualify for the $7,000 exception. This could be accomplished by adding the following language in the Committee Report accompanying S. 1350:

> "By not classifying hotels as rental real estate activities, Congress did not intend to deny investment in rehabilitated hotels the benefit of the limited rental real estate exception. Moreover, the exception from the passive activity limitation for the rehabilitation credit is premised on investment in a rental real estate activity. Therefore, solely for purposes of claiming the rehabilitation credit, a taxpayer may elect to treat a hotel as a rental real estate activity."

I would welcome the opportunity to answer any questions or discuss this matter with you or your staff.

Respectfully submitted,

Sally G. Oldham

Sally G. Oldham
Co-Chair, Committee for
Future Investment in
America's Past

COMMITTEE
FOR
FUTURE INVESTMENT
IN AMERICA'S PAST

COMMITTEE FOR FUTURE INVESTMENT IN AMERICA'S PAST
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The Committee for Future Investment in America's Past (CFIAP), a coalition of private and public sector individuals active in rehabilitation and historic preservation, suggests two technical corrections for consideration by the Committee on Finance with respect to S. 1350, the Technical Corrections Act of 1987.

First, CFIAP proposes a technical correction to section 46(c)(8) of the Internal Revenue Code, to conform the at-risk credit base rules provided for the low-income housing credit to those applicable to the rehabilitation tax credit.

Second, CFIAP suggests a technical correction to correct a situation created by certain language contained in the Senate Finance Committee Report (S. Rep. No. 99-313 at 743) to provide clearly that tax credits arising from the rehabilitation of a hotel should qualify for the $7,000 exception to the passive loss and credit limitations.

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FINLEY, KUMBLE, WAGNER, HEINE,
UNDERBERG, MANLEY, MYERSON & CASEY

COMMENTS OF
COOPERATIVE OF AMERICAN PHYSICIANS/MUTUAL PROTECTION TRUST
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
REGARDING
TECHNICAL CORRECTIONS ACT OF 1987

The Cooperative of American Physicians/Mutual Protection Trust ("MPT") wishes to thank the Committee on Finance for the invitation to comment on S. 1350, the Technical Corrections Act of 1987. MPT is a California interindemnity arrangement that provides medical malpractice coverage to approximately 2,500 physicians and surgeons in California. MPT takes this opportunity to respectfully request that the attached draft legislative language be included in some form in S. 1350. The attached language corrects three potential problems as described below, created by Section 1031(a) of the Tax Reform Act of 1986 and Section 110(g) of S. 1350, the "Technical Corrections Act of 1987" (the "Act"). This statement is submitted on behalf of the MPT by its Washington, D.C. legislative counsel, Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey.

1. Applies to Tax Treatment of Entity and not Members. The Act revised only paragraph (a)(1) of §1031 which addresses the treatment of the deductible initial contributions as income to the qualifying organization. It should be clearly stated that this change also applies for purposes of determining the deductibility of such payments by the members as provided in paragraph (a)(2).

2. Installment Payment Language Requires Modification. The Act refers to "annual installments." In practice, the Mutual Protection Trust allows quarterly payments of the annual installments of initial trust contributions (see attached schedule of installment payment plans). Therefore, to conform to existing practice, the language should be revised to eliminate the reference to annual installments and to require only that all installments be made within six years.

3. Deductibility for Subsequent Contributions is Required. Under current California law, an eligible organization's trust fund corpus is established with the initial trust contribution payments required from members upon admission. These payments are deductible to members under the provisions of §1031(a). Current California law also authorizes increases in such trust fund corpus where necessary in the best interests of the organization (and if permitted by the terms of the organization's trust agreement) through additional trust contributions by existing members.

The Mutual Protection Trust believes that the California Legislature may soon mandate such additional trust fund corpus payments from existing members, or the Mutual Protection Trust may amend its trust agreement to require such increases. The words "any initial payment" in §1031(a) could be construed to limit the deduction of trust corpus payments only to those made as part of the initial membership process. To assure that §1031(a) will apply to future contributions by existing members to increase the trust fund corpus, it is suggested that the words "any initial payment" be replaced by "any contribution to the capital of the association or to the corpus of the trust."

This revision remains consistent with the original intent of §1031(a) that payments to physicians interindemnity arrangements receive tax treatment equal to, and not more favorable than, that provided for premium payments to an independent insurance company for similar annual insurance coverage. There is no possibility that this revision could be used for any abusive tax purpose since no payments to the organization in excess of the cost of comparable insurance coverage are deductible under existing §1031(a).

If you have any questions or if further information is required, please contact Peter N. Kyros at 857-4693 or Marc J. [illegible] 857-[illegible].

<u>SUGGESTED LANGUAGE FOR INCLUSION</u>
<u>IN TECHNICAL CORRECTIONS ACT OF 1987</u>

SEC. 1031. PHYSICIANS' AND SURGEONS' MUTUAL PROTECTION AND INTERINDEMNITY ARRANGEMENTS OR ASSOCIATIONS.

SEC. 110 of the Technical Corrections Act of 1987 is amended to read as follows:

> (g) AMENDMENT RELATED TO SECTION 1031 OF THE REFORM ACT - Paragraph (1) of section 1031(a) of the Reform Act are amended by omitting "any initial payment" in Subparagraph (A) and inserting in lieu thereof "any contribution to the capital of the association or to the corpus of the trust, whether made in a lump sum or in installments over not more than six years," and by omitting "initial payment" and inserting in lieu thereof "contribution." Paragraph (2) is amended by omitting "any initial payment" in Subparagraph (A) and inserting in lieu thereof "any contribution as described in paragraph (1)," and by omitting "initial payment" or "payment" appearing throughout and inserting in lieu thereof "contribution."

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July 17, 1987

The Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
Senate Hart Building Room 703
2nd and C Streets N.E.
Washington, DC 20510

In Re: S. 1350 - Technical Corrections Act of 1987

Dear Mr. Chairman:

We are submitting these comments on behalf of a client to call your attention to a matter that we believe should be considered in the context of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350). For purposes of determining the book income adjustment under the corporate alternative minimum tax (AMT), we have discovered that in situations involving affiliated corporations not filing consolidated tax returns, intercompany dividends can generate more book income than actual dividends paid. We believe that the statute needs to be changed to rectify this inequity.

<u>The Problem</u>

Internal Revenue Code Section 56(f) provides for adjustments to book income for corporations in determining their AMT. Section 56(f)(2)(C) provides the only statutory guidance on the treatment of related corporations. This subsection provides that when consolidated tax returns are filed, adjusted book income of the taxpayer shall take into account items properly allocable to group members included in the return. When an affiliated member is not included in the consolidated return, adjusted book income shall include the dividends received from such affiliated members.

In essence, what the statute contemplates here is one book income calculation for the consolidated return group and separate calculations for affiliated members filing separate returns. The problem that arises under this approach is that dividend payments among affiliated group members that do not file a consolidated tax return are included as a book income adjustment at each level, causing the same dividend payment to be included in the book income of multiple corporations.

In our case, the corporation files a consolidated financial statement but separate tax returns. We have found that in "deconsolidating" the financial statement to compute book income for each separate corporation, dividend payments from a subsidiary to the parent result in a book income adjustment for the parent. If the dividend is paid through another subsidiary, another book income adjustment is created; if dividends are paid through multiple subsidiaries, a book income adjustment is created at each level. This multiple counting creates a penalty for not filing a consolidated tax return that we believe is unwarranted and requires legislative action to correct.

<u>The Proposed Regulations</u>
The Treasury Department's recently proposed regulations regarding the corporate AMT book income adjustment do not resolve this matter. Under Prop. Reg. §1.56-1T(d)(6)(i)(C), if consolidated financial statements are used but separate tax returns are filed, to determine adjusted net book income of the parent corporation and of the subsidiaries, any consolidating eliminating entries attributable to the separate companies must be removed. This means that any consolidating, eliminating entries that were used to eliminate the double counting attributable to intercompany dividends must be "backed-out" in reaching adjusted net book income.

With respect to the subsidiaries, their adjusted net book incomes would reflect dividends received from other related corporations as reported in their separate financial statements (presumably trial balances made available to the parent for consolidation purposes). Prop. Reg. §1.56-1T(c)(5)(i)(C). No adjustments would evidently be permitted to eliminate the double counting of separate company intercompany dividends.

Because no adjustment seems to be allowed under the proposed regulations for dividends paid to affiliated companies not filing consolidated tax returns, income is created for book income addition purposes that has been taxed at another entity level. This effectively creates a penalty for not filing a consolidated tax return.

<u>Illustration</u>
When a consolidated financial statement is "deconsolidated" to determine a book income amount for each subsidiary filing its own Federal income tax return, the potential for double counting is introduced. If not eliminated through adjusting entries, we have found that this problem is exacerbated when intercompany dividend payments are made to the parent through tiers of subsidiaries.

The following example illustrates this problem:

Parent Corporation, a calendar-year corporation, holds a wholly owned subsidiary, X, which in turn is a holding company for the stock of Y, an operating subsidiary. In 1987, Y has $100 of earnings and out of those earnings pays a $100 dividend to X. X in turn pays a $100 dividend to Parent, which distributes the dividend to its shareholders. Parent, X and Y have no other earnings. Parent, X and Y use a consolidated financial statement, but file separate Federal income tax returns.

For AMT purposes, it appears that the 1987 book income additions for Parent, X and Y under IRC §56(f) are computed separately as follows:

Book income addition for Y:

	TAX		BOOKS
Operating Income	$100	Operating Income	$100
Taxable Income	$100	Net Book Income	$100

Y's BOOK INCOME ADDITION TO AMTI $-0-

Book income addition for X:

	TAX		BOOKS
Dividend Income from Y	$100	Dividend Income from Y	$100
Dividends received deduction	(100)		-0-
Taxable Income	$-0-	Net Book income	$100

X's BOOK INCOME ADDITION TO AMTI $50

Book income addition for Parent:

	TAX		BOOKS
Dividend Income from X	$100	Dividend Income from X	$100
Dividends received deduction	(100)		-0-
Taxable Income	$-0-	Net Book Income	$100

PARENT'S BOOK INCOME ADDITION TO AMTI $50

Summary for Parent, X and Y:

	Consolidated Return	Separate Returns
Total Net Book Income	$100	$300
Total Taxable Income	$100	$100
Total Book Income Addition to AMTI	$-0-	$100

If Parent, X and Y had filed a consolidated tax return for 1987, no book income addition would be required because consolidating, eliminating entries on the books would have eliminated any difference between book and tax. Because separate tax returns are filed for Parent, X and Y, book income additions totaling $100 ($50 from X and $50 from Parent) are created, potentially triggering the corporate AMT for X and parent.

Note: If Parent had additional tiers of subsidiaries, each tier would have another $50 book income addition. For example, if three tiers of subsidiaries were involved, book income additions would total $150, an amount in excess of the $100 dividend paid.

Recommendation

Congress intended that the book income addition would compel corporations to pay at least some tax when reporting substantial earnings to the public. In this situation, because a consolidated financial statement is prepared, there are no earnings being reported for book purposes that are not reported for tax purposes as a result of intercompany dividends. There is no question of untaxed income. It is only because the taxpayer files separate tax returns for parent and subsidiaries that a book income addition is created. This rule creates an unwarranted penalty for not filing a consolidated tax return and unfairly penalizes those who cannot file a consolidated return or choose not to do so.

To eliminate the double counting of intercompany dividends in this context, we recommend that the inequity in the book income adjustment for a group of related companies not filing a consolidated income tax return be eliminated by providing a statutory rule for an adjustment to net book income for intercompany dividends paid when a consolidated financial statement is used.

Thank you for your attention to this matter. If you have any further questions, please contact Pamela Pecarich or Sam Starr of National Tax Services at 202/822-4000.

Sincerely,

David T. Wright
National Director of Tax Services

SPS/lp

TESTIMONY OF MICHAEL MALONE

Dean of Graduate Studies at
Montana State University

SUMMARY OF POINTS OF THE TESTIMONY OF DR. MIKE MALONE

- An apparent inconsistency exists between section 117 which would tax tuition remission scholarships provided to graduate teaching and research assistants and section 127(c)(8) which would exclude such amounts from taxation.
- The legislative history supports a clarification in favor of section 127 over section 117 (not subjecting such scholarships to tax).
- Such a determination is clearly consistent with the general tax reform policy in this area that tuition scholarships should be exempt from tax but room and board should be taxable.

Mr. Chairman, I am Dr. Mike Malone, and am the Dean of Graduate Studies at Montana State University at Bozeman. I am appearing on behalf of the Council of Graduate Schools in the United States. I am here today in support of a proposed technical correction to section 127(c)(8) (copy attached). This correction assures that the intent of the conferees in extending section 127 is carried out; namely that graduate students engaged in teaching and research can continue to exclude from taxable income their tuition remissions grants. The correction serves to resolve any inconsistencies between section 117's provisions for qualified scholarship exemption and section 127(c)(8)'s exclusion for tuition remission grants.

The core problems are as follows: 1) although Section 117 generally exempts scholarships and fellowships up to a ceiling of tuition and fees from taxation, it subjects to taxation all payments that represent compensation for services, presumably to include tuition remissions for TAs and RAs (teaching and research assistants); 2) this treatment of TA and RA tuition remissions is now in conflict with 127(c)(8), which states that such support is tax-exempt; 3) Congress should resolve the conflict in favor of 127(c)(8) because that is the proper policy at the graduate level where teaching and research are a fundamental part of the educational process and because that implements Congressional intent as stated in the House Report. Congress should also correct the language in Section 117 to end the awkward cross-reference.

Early in the House consideration of the Tax Reform Act of 1986, it was decided to make the non-tuition portion of scholarships and fellowships subject to tax. We do not believe that there was any debate over the status of fellowships that contain teaching or research components. At a later date in the development of the 1986 Tax Bill, section 127 was extended to continue employer-provided tuition benefits. Section 127(c)(8) excludes tuition reduction grants from taxable income even where some teaching or research is required. The House Report (H. Report 436, 99th Congress, 1st Session 102, 7 Dec. 1985) makes note of this as follows:

> "In addition, section 1161 of the committee bill extends the availability of the tuition reduction exclusion for certain graduate students an additional two taxable years beyond its scheduled expiration for taxable years beginning after December 31, 1985, as part of the extension of section 127 under the bill."

No specific mention of these topics is made in the Conference Report on the Tax Reform Act except the general notation that the conferees adopted the House provisions.

Given the peculiar cross-reference between section 117 and section 127, it is understandable why confusion exists. However, what legislative history that does exist on this obscure provision (H. Report language) seems to strongly indicate that until section 127 expires at the end of 1987, graduate students could continue to exclude tuition remission scholarships.

Section 127 was added to the code to allow employers to provide non-discriminatory education benefits to their employees. Prior to its adoption great confusion existed as to what was excludable under section 162 as an ordinary and necessary business expense (retraining) and what was not excludable (new skills). A similar situation exists in this case as well. Trying to separate out in the case of a graduate research assistant in molecular biology what amounts of his/her tuition waiver constitutes compensation for some type of service and what constitutes an educational activity is almost impossible. The sounder tax policy is clearly to recognize that the primary purpose of tuition waivers is not compensation, but education. Most of the services provided have extremely limited, if any, commercial value. Where stipends are provided as payment for services a taxable event occurs. This is consistent with the 1986 revisions to Section 117. Section 127 rightly excludes tuition remission grants from taxation. In addition, such a result is completely consistent with the primary provision in tax reform which subjected room and board to taxation, but continued to provide tax-free tuition scholarships. A result contrary to the one we are seeking would produce the anomalous situation in which an individual could receive a tax-free scholarship to study geology, but an individual who receives a tuition scholarship to study biology which had a teching or research requirement would be subject to tax.

Thank you for this opportunity to testify. I hope that the Committee adopts our proposed clarification. I'd be pleased to answer questions about our policies at Montana State University or any other aspects of this issue.

PROPOSED CORRECTION

In order to clarify the scope of the cross-reference to Section 117(c) contained in Section 128(c)(8), the following technical amendment should be adopted:

Paragraph (8) of Section 128(c) is amended to read as follows:

> "COORDINATION WITH SECTION 117(d). -- In the case of an individual who is a graduate student at an educational organization described in Section 170(b)(1)(A)(ii) and who is engaged in teaching or research activities for such organization, Section 117(d)(2) shall be applied as if it did not contain the phrase "below the graduate level" <u>and without regard to the limitation contained in paragraph (c) of that Section [117]</u>."

TESTIMONY OF LAWRENCE B. SIMONS

On Behalf Of

THE COUNCIL OF STATE HOUSING AGENCIES

Mr. Chairman, members of the Subcommittee, my name is Lawrence B. Simons, and I am pleased to appear before you on behalf of the Council of State Housing Agencies to address certain provisions of the proposed Technical Corrections Act of 1987 (S.1350), as they relate to the low income housing tax credit. The Council of State Housing Agencies represents housing finance and credit agencies in all fifty States plus the District of Columbia, Puerto Rico and the Virgin Islands. These agencies have been charged with administration of the tax credit program. In appearing before you this morning, Mr. Chairman, I am also expressing the views of an additional eleven organizations, ranging from the National Association of Home Builders to the National Low Income Housing Coalition, which have written to the Finance Committee with respect to the Technical Corrections legislation. I would request your permission to insert in the record the communication of the twelve organizations to Chairman Bentsen, together with their more detailed comments on S.1350.

I would like to begin by expressing the gratitude of the housing community to the Finance Committee for the very important improvements which the Technical Corrections bill would make in the low income housing tax credit statute. As you know, in the tax credit provisions of the 1986 Tax Reform Act, the Congress made a virtually complete break with the history of federal tax incentives for rental housing in general, and low income housing in particular. It did so without one day of hearings on the tax credit proposal and with little opportunity for extended discussion among the members. In light of the way in which the tax credit proposal was enacted, it is not surprising that it contained a great many serious technical flaws. S.1350, combined with various clarifications of Congressional intent which were expressed in the General Explanation of the Tax Reform Act of 1986 (the "Blue Book"), would go a very long way to correcting these problems. The purpose of my testimony this morning is to identify those few areas in which S.1350 does not provide an adequate remedy.

The most needed change involves modification of the prohibition on carryover of a credit allocation from one year to the next. Under current law, a project must be placed in service in the specific year with respect to which it has been granted a credit allocation. If it is not completed and in service by the end of that year, the credit allocation is lost -- both to the project and to the State which provided it.

Mr. Chairman, this is a totally unworkable requirement. After more than twenty years as a builder, I can assure you that the completion date on a multifamily project is, at the very best, an optimistic guess, a guess that can easily be off by twelve months or more. Whether the results of contractor problems in New York, unpredictable weather in Montana, environmental litigation in California or permitting problems in Illinois, multifamily construction is very vulnerable to delays. Because of this, when I was responsible for the administration of all HUD housing programs, we <u>never</u> had a mandatory completion date for our projects. We required developers to <u>commence</u> construction within twelve months or twenty-four months, depending upon the program, in order to assure that commitments would actually be used. But we never had a completion date, because we knew that, first, developers had every incentive to complete the projects as quickly as they could, and second, that completion dates are unpredictable. I would add that we routinely extended the dates by which construction had to be commenced, if the developer demonstrated a reason for such a delay.

Mr. Chairman, no developer will commence construction -- or even obtain financing -- in reliance upon the tax credit if he knows that a delay of any sort will cause the loss of that critical incentive. The effect is particularly severe on the more ambitious projects which involve combinations of assistance, development in troubled neighborhoods, extensive community involvement and so on. These projects require a long lead time in order to get the various pieces into place, and require constant adaptation as construction proceeds. These are precisely the kinds of projects that we ought to be encouraging with the tax credit. These are precisely the kinds of projects that the no-carryover rule will eliminate. In addition, by forcing developers to rush to meet a completion date, the statute can increase both construction costs and hazards.

Acknowledging this problem, the drafters of the Technical Corrections bill provided, in Section 102(1)(17), that a credit allocation could be carried over to the succeeding taxable year if the initially projected completion date was reasonable and the delay was caused solely by unforeseen conditions which were not within control of the taxpayer. Unfortunately, this rule is simply inadequate. A developer cannot afford to risk his investment on the hope that, should a delay occur, a Treasury Department official will, after the fact, determine, first, that the initially projected completion date was "reasonable", second that the delay was caused "solely" by unforeseen circumstances, and third that those unforeseen circumstances were beyond the developer's control.

The housing groups propose a simpler, more workable standard than that contained in the bill. Carryover should be permitted where at least half the cost of a project has been incurred by the end of the allocation year, and where the project is placed in service in the following year. I would add, Mr. Chairman, that in my judgment even this rule is unnecessarily stringent. Congress already has a perfectly good carryover rule in the tax exempt bond provisions, permitting bond authority to be carried over for three years if it has been allocated for a specific purpose or to a specific project. The same principle can easily be applied to the tax credit. If an allocating agency commits funds to a specific project by the end of the allocation year, the project should have three years to come into service.

Note that this rule is still more stringent than the bond rule, since under the bond rule one need only issue bonds for a project, whereas under the credit carryover proposal, one would have to complete construction. Still, I believe a three-year time period following a commitment of credit authority is consistent with general industry practice and would be workable.

Permitting carryover of bond allocations might well produce a savings to the Federal Government. While it has been claimed that the absence of a carryover rule would result in the loss of credit allocation for most states, I submit that the more likely occurrence is that as a year winds down, allocating agencies will look around for projects that are just going into service or have already gone into service to allocate credit to. As a result, the credit allocations will be used, but they will be used on existing projects which were developed without any intention of using the tax credit and which are already in service. On the other hand, if carryover is permitted, allocations will go to projects that are specifically dependent upon the credit, projects that will not go into service for several years. Accordingly, revenues will be saved.

A second matter which I would like to bring to your attention concerns the most significant housing problem confronting the Federal Government today -- the preservation of the existing supply of assisted housing. With restrictions expiring on hundreds of thousands of units of assisted housing built in the mid-1960s and early 1970s, the Banking Committees have made their top priority the retention of this stock for lower income use. Ironically, this is the one area in which the technical corrections legislation, as introduced, would take a step backwards.

The tax credit statute currently denies credit on the acquisition cost of an existing project if the project has changed hands within the preceding ten years. Treasury may waive this restriction for certain federally-assisted projects (i) in order to avoid an assignment of the mortgage to HUD or FmHA, (ii) to avoid a claim against a federal mortgage insurance fund or (iii) "by reason of other circumstances of financial distress." This last category was interpreted by the housing community to permit waivers in the case of federally-assisted projects which were not insured by HUD, but which were financed by state agencies. Section 102(1)(7) of S.1350 would strike this last clause, thereby eliminating approximately half of the assisted housing projects -- representing perhaps 400,000 units -- which might otherwise be eligible for the waiver.

This provision moves precisely in the wrong direction. The Congress ought to be working to expand the use of the credit with the inventory of federally-assisted housing. Housing groups have proposed an amendment which would permit the tax credit to be used for all distressed projects, which are either federally-assisted, federally-financed or federally-insured. The entire inventory of federally-related housing should be viewed as a present or potential resource for lower income people and a prime target for use of the credit.

There is no cost to this amendment, since any use of the credit proposal with such projects would have to come within the currently existing state caps. In addition, there is no likelihood for churning or abuse, since the credit can only be used with projects that the applicable federal or state agency has determined to be in financial distress or in danger of being converted to non-low income use.

A third area deserving of particular attention involves the current inability to use the credit in the nation's poorest areas. The limits for lower income tenants in the program are 50% or 60% of the area median income, depending on whether the "20-50 test" or "40-60 test" is used. Rents are restricted to 30% of the applicable income ceiling. In the poorest areas of the country, these restrictions combine to produce permissible rents so low as to make it impossible to support construction. Rural housing groups have determined that, even combined with Farmers Home Administration subsidies which lower interest rates to 1%, the tax credit income restrictions make the program unworkable in 68 out of 75 counties in Arkansas, 54 out of 101 counties in Kansas, 19 out or 20 counties in Maine, 44 out of 87 counties in Minnesota, and so on. In dollar terms, the income limits mean that in 14 counties in Mississippi where median incomes are $16,000 or below, the maximum rent you can charge for an apartment unit is $240.00, less a utility allowance. In 38 Texas counties, with incomes of $20,000 or below -- compared to a $28,000 State median -- the maximum rent you can charge is

$300.00, less utilities. Mr. Chairman, you cannot build even subsidized housing at these rents.

We propose that, as the law currently allows with regard to mortgage bonds, allocating agencies be permitted to use the higher of the state median income or the county median income. This rule will cost nothing, but it will open up the tax credit program in the neediest counties in this nation.

The other improvements which we seek in S.1350 are more technical in nature. First, we are seeking clarification that federal or state rental assistance is not to be counted as a tenant payment for purposes of the so-called "deep rent skewing" provisions. Under these provisions, special treatment is provided for projects in which market rate rents are at least 3 times the rents charged to lower income households, and at least 15% of the lower income units are allocated to households at 40% of the area median income or below.

S.1350 provides that, consistent with the rest of the credit law, rental assistance payments are to be disregarded for purposes of determining the maximum rent paid by low income tenants. It provides, however, that those assistance payments are to be counted for purposes of determining the 3-to-1 ratio between market rents and low income rents. Beyond its inconsistency, this provision effectively makes the deep rent skewing provision unworkable in the single context in which might otherwise have some value -- that is, a partially assisted, subsidized project in a high-cost area. In my judgment, this is the only circumstance in which any owner would have an incentive to elect deep rent skewing treatment, and yet the inconsistent and irrational treatment provided by S.1350 would make deep rent skewing unusable. Rental assistance payments should not be counted as tenant rent payments -- since they are not tenant rent payments -- for all purposes under the tax credit, including the 3-to-1 ratio under deep rent skewing.

In another matter, I would note that perhaps the first "technical amendment" to the credit statute was contained in the 1986 budget reconciliation bill. This amendment eliminated a provision that would have effectively denied the tax credit to projects which received more than 80% non-recourse financing.

This provision, a carryover from the at-risk rules applicable to tax credits in areas other than real estate, simply ignored the fact that low income housing is absolutely dependent upon non-recourse mortgage financing. When the provision was discovered, Congress acted quickly to eliminate it. In the effort to deal with the 80% provision, however, a more obscure requirement of the at-risk rules was overlooked. This requirement effectively excludes even bona fide non-recourse financing from the tax credit base, if the property was acquired from a related person. Since most development and syndication transactions involve some level of dealing among related parties, this constitutes a significant obstacle. It should be eliminated. I would stress, Mr. Chairman, that we believe this provision to have been an oversight in the initial statute, and since there are a number of rules in the tax code which already address related party transactions directly, there is no need to provide this "back-door" restriction through the at-risk rules.

Another proposed technical amendment would clarify that the so-called "35 partner election", which enables a partnership to avoid tax credit recapture so long as the project continues to comply with low-income requirements, applies to two-tiered partnerships. Under such arrangements, there are only two partners in the partnership which actually owns the property -- a general partner and an investor limited partnership. The second tier -- the investor limited partnership -- will have 35 or more members. This is the way in which HUD normally requires partnerships to be structured for the ownership of assisted housing. The statute should make clear that such a partnership would qualify under the 35 partner rule.

We are also seeking clarification on the definition of "eligible basis." Specifically, the statute provides that the eligible basis of a building is determined on the date such building is placed in service. This definition leaves unclear the status of routine "build-out" expenditures incurred after the in-service date. The bill should specify that the eligible basis of the building is determined at the time that the building's qualified basis is determined, which would be either the last day of the taxable year in which the building is placed in service or the last day of the succeeding tax year.

In conclusion, Mr. Chairman, I would note that while the combination of amendments already in S.1350 and those which we are seeking would remove serious technical obstacles to the use of the credit, it is a long way from being the efficient tax incentive which is needed for lower income housing. The most serious substantive problem is the passive loss rule, which, as it applies to tax credit projects, effectively eliminates what had been the primary market for low income housing investments -- "accredited investors." As a result, tax credit projects must be sold either through large public syndications or to an entirely new corporate market. This creates enormous inefficiency through high transactional costs and a lengthy educational process. In short, the passive loss rules mean that the taxpayer is getting very little in return for the substantial subsidy dollars being put into the low income tax credit.

I would hope that the Finance Committee, in the near future, will take a more detailed look at the tax credit and address this problem, as well as a number of other significant substantive questions. These include the penalties on using tax credits with other federal subsidy programs, the inability on the part of state agencies to increase the credit percentage for worthy projects, and the burdens placed on a project when tenants go over-income.

Mr. Chairman, I am grateful for your concern and look forward to the Finance Committee's Technical Corrections Bill. Thank you very much.

SUMMARY OF TESTIMONY -- LAWRENCE B. SIMONS

The Technical Corrections Legislation (S.1350) makes very significant improvements in the tax credit statute, but additional change is needed in the following areas:

1. Carryover of tax credit authority. A project must be placed in service by the end of the allocation year. S.1350 would permit carryover of post-1987 credit where the delay was caused by unforeseen circumstances beyond the control of the taxpayer. The current rule is unworkable and the technical amendment does not provide sufficient relief. The rule should be that if credit authority is committed to a specific project within the allocation year, it may be carried over for up to three years to permit the project to be placed in service. Another solution would be to permit carryover of credit where at least 50% of the project's cost has been incurred by the end of the allocation year and the project is placed in service in the subsequent year.

2. Expanded use of ten-year waiver. Congress should permit waivers of the ten-year rule in the case of any federally-assisted, -financed or -insured project in financial distress or in danger of being converted to non-low income use.

3. Income limits. Allocating agencies should be permitted to elect the higher of the county median income or the state-wide median income for purposes of the various income tests.

4. Deep rent skewing. S.1350 would provide that rental assistance payments are not counted as tenant payments for purposes of the rent restrictions under the deep rent skewing provisions. The same rule should apply to the requirement that market rents be at least three time tenant payments in low income units.

5. At-risk rules. Section 42(k)(1) should be modified to add section 46(c)(8)(D)(iv) to the categories excluded from the application of the at-risk rules to the tax credit.

6. Thirty-five partner rule. The statute should be clarified to permit application of the 35-partner exception to the recapture rules to two-tiered partnerships.

7. Eligible basis. "Eligible basis" should be determined at the same time that "qualified basis" is determined.

Beyond the technical corrections, important substantive changes are needed to make the tax credit program more efficient and useful. The most important of these is modification of the passive loss rule as it applies to the tax credit.

Chevron Corporation
225 Bush Street, San Francisco, CA 94104-4289

Louis Fernandez, Jr.
Vice-President

July 15, 1987

Tax Reform Act of 1986
Technical Corrections Act
(H.R. 2636 and S. 1350)

Code § 72 Basis Recovery

Senator Lloyd Bentsen, Chairman
Senate Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20515

Dear Chairman Bentsen:

On behalf of thousands of Chevron Corporation and former Gulf Oil Corporation employees, we offer the following comments on H.R. 2636 and S. 1350, the proposed Technical Corrections Act of 1987. Our comments relate to troublesome technical problems concerning the taxation of pension plan distributions. In addition, we offer what we hope is a reasonable suggestion for resolving the issue.

As you may recall, Chevron acquired Gulf Oil Corporation in 1984. Effective July 1, 1986 the defined benefit plans of both corporations were merged into what is now the Chevron Retirement Plan. Thousands of active employees made contributions many years ago to the qualified retirement plans of both corporations, but the merged Plan is no longer contributory.

The Plan provides a form of distribution consisting of a lump-sum refund of employee contributions (and interest) plus a reduced annuity. Under prior law, employee contributions could be recovered first if the refund plus annuity option was selected. The new law preserves this treatment, but only if the refund is received before separation from service. Our refund is paid after separation from service but before the reduced annuity payments commence. Therefore, our refund is not eligible for the new law basis-recovery-first rule.

Under the new law, many retiring employees are now subject to complex "exclusion ratio" rules under which they are deemed to recover their own after-tax contributions gradually over the many years of retirement. The new rules cause great consternation among retirees and are difficult and expensive to administer.

We firmly believe that these problems are not justified by the small amounts involved and could be handled more simply by a "transition rule" or "de minimis" exception that would permit tax-free recovery as under prior law. Using active Chevron employees as an example, we estimate that under the new rules their average contributions of about $1,600 would result in an annual tax-free recovery of less than one percent of their annuity payments. It would be simpler for all, including the IRS, if these amounts could be recovered when the annuity first commences. Obviously, any revenue effect would be minuscule.

Section 111A(b) (11) of H.R. 2636 and S. 1350 extends the new law basis-recovery-first rule to refunds just like ours, but the section is limited to state plans. We ask for a narrow transition rule making section 111A(b) (11) treatment available to participants in other plans, at least where (1) the employee contributions were made before ERISA, and (2) the amount of employee contributions being recovered is relatively small ($7,500 or less).

Enclosed is a memorandum which describes this issue in detail and includes possible statutory language that might be used to accomplish the suggested changes.

We thank you for your consideration of this suggestion. If you or your staff desire further information or wish to discuss this issue, please do not hesitate to contact me or our Washington representative, Mr. Kevin Riordan at 457-5800.

Sincerely,

ORIGINAL SIGNED BY
LOUIS FERNANDEZ JR

FACTS

Chevron Corporation acquired Gulf Oil Corporation in 1984. Chevron maintained the Chevron Annuity Plan and the Gulf Pension Plan (both defined benefit pension Plans), which were merged on July 1, 1986 to form the Chevron Retirement plan. Until 1971, the Gulf Plan had an employee contribution feature and, until mid-1971, the same was true of the Chevron Annuity Plan. Both Plans credited the employee contribution amounts with a stated amount of interest until distribution. No in-service withdrawals of employee contributions were ever permitted under either Plan.

As of 12/31/86, about 20% of the active employees participating in the merged plan had a balance of after-tax contributions made before mid-1971. The following table shows the distribution of the amount of contributions made by these 8,500 active employees.

Amount of Contributions				
$ 0	to	1,000	=	47.0%
1,000	to	2,000	=	22.0
2,000	to	3,000	=	14.0
3,000	to	4,000	=	10.0
4,000	to	5,000	=	4.0
5,000	to	6,000	=	1.5
6,000	to	7,500	=	1.0
Over	to	7,500	=	0.5
				100.0%

Under the pre-merger Gulf Plan, the so-called "Option C" form of distribution allowed a participant who retired and was entitled to receive his benefits to elect to receive a lump-sum refund of his employee contributions plus interest, and an annuity actuarially reduced to reflect the refund of those employee contributions plus interest.

After the merger of the Gulf and Chevron Plans on July 1, 1986, Option C was retained for former Gulf employees and, if the problems under the 1986 Act can be satisfactorily resolved, it may be extended to all participants.

The Chevron Retirement Plan provides for individual life and for 50% and 100% joint and survivor forms of annuity distribution, either in combination with or without the Option C refund feature described above. The Plan also provides a lump sum form of distribution.

THE LAW RELATING TO "OPTION C"

Under the Code prior to the Tax Reform Act of 1986 ("1986 Act"), if a qualified pension plan made a distribution before a participant's annuity starting date of an "amount not received as an annuity," the distribution was includible in the participant's gross income only to the extent it exceeded the participant's investment in the contract, or basis. Such an amount received on or after the annuity starting date was fully included in income. As amended by the 1986 Act, present law provides generally that a pre-annuity starting date distribution of an amount not received as an annuity is subject to the new pro-rata basis recovery rules. However, under new Code section 72(e)(8)(D) pre-1987 basis may be recovered first if the plan permitted in-service withdrawals of employee contributions on May 5, 1986. An amount not received as annuity that is made on or after the annuity starting date continues to be fully includible in gross income under both old law and present law.

DISCUSSION OF OPTION C ISSUES

Under present law, retiring Chevron Retirement Plan paticipants electing Option C can only recover their old employee contributions first if the Plan could meet the requirements of new Code section 72(e)(8)(D). However, ensuring that the lump sum refund payment always actually precedes the annuity starting date is sometimes difficult because the annuity starting date can be as early as the first day of the month coinciding with or following retirement. In fact, the first annuity check is actually issued at the end of that month for that month. Moreover, even if Chevron could resolve the annuity timing problem, the Plan would be barred from Code section 72(e)(8)(D) treatment for the simple reason that on May 5, 1986, it did not permit withdrawals of employee contributions before separation from service, even though it did permit them (in the form of the Option C election to receive a lump sum refund) at separation from service.

If the basis-recovery-first rule under Code section 72(e)(8)(D) were made available to retiring Chevron Plan participants, the revenue loss would be insignificant, and the tax treatment not inconsistent with Congress' reasons for changing the law. In its General Explanation of the Tax Reform Act of 1986 (the "Bluebook"), the Joint Committee on Taxation states that Congress believed that the prior "basis recovery rules for distributions before retirement permitted the accelerated tax-free recovery of employee contributions and thus further encouraged the use of tax-favored retirement arrangements for nonretirement purposes." Since a basis-recovery-first rule under the Chevron Plan would only apply to participants terminating employment, and would only allow the accelerated tax-free recovery of a very small benefit (the employee contributions made more than 10 years earlier), it would not encourage the use of the Plan for nonretirement purposes.

SUGGESTED TECHNICAL CORRECTION FOR OPTION C

Section 111A(b)(11) of the Technical Corrections Bill amends section 1123(h) of the 1986 Act in such a way that, if it were applicable to the refund of employee contributions and interest under the Chevorn Retirement Plan, the participant could recover his basis first from the "Option C" lump sum refund, so long as it was paid with or before the first annuity payment. However, the rule of this section is only applicable "(i)n the case of a plan maintained by a State which on May 5, 1986, permitted withdrawal by the employee of employee contributions (other than as an annuity)."

We anticipate that Congress would be unwilling to increase the availability of section 111A(b)(11) to any great extent. Therefore we suggest that it be limited to plans that do not currently allow employee contributions and further limited to those plan participants whose employee contributions were made more than 10 years ago. If it is felt necessary, this relief could be further limited to situations where there is only a small amount of employee contributions. The following revision to section 111A(b)(11) retains the current rule for State plans and extends it as we have suggested:

"(11) Section 1123(h) of the Reform Act is amended by adding at the end thereof the following new paragraph:

'(9) SPECIAL RULE FOR CERTAIN PLANS. - -

(a) IN GENERAL. - - In the case of any plan to which this paragraph applies, section 72(e) of hte Internal Revenue Code of 1986 shall be applied - -

(i) without regard to the phrase 'before separation from service' in paragraph 8(D), and

(ii) by treating any amount received (other than as an annuity) before or with the first annuity payment as having been received before the annuity starting date.

(B) PLANS TO WHICH THIS PARAGRAPH APPLIES. - - This paragraph shall apply to any plan - -

(i) maintained by a State which on May 5, 1986, permitted withdrawal by the employee of employee contributions other than as an annuity), or

(ii) which on May 5, 1986, did not permit employee contributiosn to be made ot the plan.

This paragraph shall apply with respect to an employee participating in a plan described in clause (B) (ii) only to the extent that all of the employee contributions credited to the employee under the plan (or a predecessor plan) on May 5, 1986 had been made to the plan (or a predecessor plan) prior to 1976."

Clause B(ii) could be further limited to make absolutely certain that the basis-recovery-first rule is available only to participants with small amounts of employee contributions by the addition of the following at the end of this suggested section 1123(h)(9) of the 1986 Act:

"and do not exceed $7,500 on May 5, 1986."

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July 17, 1987

William J. Wilkins, Esq.
Chief Counsel
219 Dirksen Building
United States Senate
Committee on Finance
Washington, D.C. 20510

Re: Submission for the Record on S. 1350, the Technical Corrections Act of 1987

Dear Rob:

On behalf of our client, the Chrysler Corporation, I would like to take this opportunity to submit the following comment for the record on S. 1350, the Technical Corrections Act of 1987. It suggests a correction to the auto manufacturing facility investment tax credit transition rule that was intended to cover three Chrysler plants.

The Tax Reform Act of 1986 (Pub. L. No. 99-514) (the "Act") repealed the investment tax credit, effective generally for property placed in service after December 31, 1985. A number of transition rules were provided, however, for taxpayers who had substantially and reasonably relied on prior law in making investment decisions. Among those transition rules was one for certain auto manufacturing facilities that was intended to cover three plants owned and operated by the Chrysler Corporation (the "Company") in St. Louis, Missouri and Belvidere, Illinois (section 204(a)(5)(J)(ii)(II) of the Act).

As enacted by Congress, the auto manufacturing facility transition rule intended to apply to the Chrysler plants is defective in that the data used to identify the plants is

William J. Wilkins, Esq.
July 17, 1987
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incorrect. The Company submitted preliminary project data to assist the Joint Committee on Taxation in developing the scope of a revenue estimate for a generic auto manufacturing transition rule. This data had been subsequently refined prior to formal approval by the Company's Board of Directors, and therefore was not appropriate for use as a project identifier in the auto manufacturing plant specific rule approach ultimately adopted by the conferees. It should be noted that no facts or circumstances in the development of these three plants have changed since the enactment of the Act. The three projects that the conferees intended to cover remain the same three plants at the same locations producing the same cars that were described to the conferees. In fact, the Company's estimates indicate that the rule when corrected will have a federal revenue impact of approximately $7 million less than originally anticipated.

Therefore, in order to effectuate the Congressional intent underlying this rule, the Company respectfully requests that section 204(a)(5)(J)(ii)(II) be amended to read as follows:

> "(II) the Board of Directors of an automobile manufacturer approved a written plan for the conversion of [an] existing facilit<u>ies</u> to produce [a] new model<u>s</u> of a vehicle not currently produced in the United States, such facilit<u>ies</u> will be placed in service by July 1, 1987, and such Board action occurred in July 1985, with respect to a [$523,000,000] <u>$602,000,000</u> expenditure, [in June 1983, with respect to] a [$475,000,000] <u>$438,000,000</u> expenditure, [or in July 1984, with respect to] <u>and</u> a [$312,000,000] <u>$321,000,000</u> expenditure."

We appreciate this opportunity to comment on the technical corrections legislation and look forward to working with you and your staff on this issue.

Sincerely,

John

John J. Salmon

Attachment

SCRIBNER, HALL & THOMPSON
SUITE 1100
1850 K STREET, N. W.
WASHINGTON, D. C. 20006-2201
(202) 331-8585

July 17, 1987

William Wilkins
Majority Staff Director
and Chief Counsel
U. S. Senate Committee
on Finance
205 Senate Dirksen Office Bldg.
Washington, D.C. 20510

Re: Technical Correction to I.R.C. §832(b)(4) -- to Eliminate a Double Disallowance of Deduction for Certain Acquisition Expenses

Dear Mr. Wilkins:

We are submitting the attached document on behalf of CNA Insurance Companies, Chicago, Illinois. The document briefly describes a technical problem presented by the 20-percent adjustment to unearned premiums in I.R.C. §832(b)(4) that was adopted by Congress in the Tax Reform Act of 1986.

We believe that CNA is one of just four companies that follow the holding in Western Casualty and Surety Company v. Commissioner, 571 F.2d 514 (10th Cir. 1978) and do not deduct commissions relating to deferred premium installments when the policy is issued, although such installments are reflected in unearned premiums. The Western Casualty method of accounting combined with the recently adopted 20-percent adjustment to unearned premiums causes a double adjustment for these acquisition expenses.

Please consider this letter as written comments on S. 1350, submitted to the Senate Finance Committee for its formal consideration.

Sincerely,

Susan J. Hotine

Susan J. Hotine

SJH/kks
Enclosure

cc: Richard Meltzer
Winston & Strawn

COLLEGE OF NEW ROCHELLE
OFFICE OF THE PRESIDENT

July 16, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Re: Technical Corrections Bill (S. 1350)
Charitable Gift Annuities

Dear Ms. Wilcox:

I would strongly urge that the Technical Corrections Act of 1987 (S. 1350) be amended to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC 501(m).

The College of New Rochelle, an independent College, with predominantly women graduates, offers Charitable Gift Annuities as a life income program for older graduates who are not wealthy enough to establish large Charitable Remainder Trusts. The proceeds from these annuities ultimately revert to the College's endowment.

I'd like to outline the following for the Committee's consideration:

1. Charitable Gift Annuities are used because an interested donor wants to make a gift to help the College of New Rochelle and yet needs to retain a small life income.
2. We do not feel that gift annuities compete with commerical annuities and are not "commercial-like insurance."
3. Congressional failure to clarify the law would dry up an important source of funds for the College of New Rochelle and similiar small independent colleges offering a variety of ways of making gifts to higher education.
4. Gift Annuities are not new and have been used for more than 100 years.
5. Gift Annuities are primarily for the small donor. A Charitable Gift Annuity is the equivalent of a large donor's Charitable Remainder Annuity Trust, which remains unaffected by IRC Sec. 501(m).

Higher education is in great need of voluntary financial support and I thereby urge that S. 1350 be amended to clarify that Chraitable Gift Annuities are not subject to IRC Sec. 501(m).

Sincerely,

Dorothy Ann Kelly, osu

Sister Dorothy Ann Kelly, O.S.U.
President

SDAK/bar

NEW ROCHELLE, NEW YORK 10801
(914) 632-5300

PLANNED GIVING PROGRAM

COLLEGE OF MOUNT ST. JOSEPH ON THE OHIO

July 28, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20515

Action: CHARITABLE GIFT ANNUITIES

Dear Ms. Wilcox:

I urge you to support and vote for the Technical Corrections Act of 1987 (H.R. 2636) with the addition of Sec 501 (m) wording that excludes "Charitable Gift Annuities" under the provisions of that section.

Charitable gift annuities are one of the few giving instruments available for developing endowments at private colleges and universities. As you know, endowments help to assure the long-term financial stability of colleges like the Mount. Gift annuities are used by loyal alumni and friends who would like to make a gift to the College and who are interested in supporting endowment development in higher education but who are in need of income during their retirement years.

Gift Annuities do not compete with commercial annuities and are not commercial-type insurance. Failure to clarify the current law will virtually eliminate gift annuities as an important source of funds enabling private colleges to continue the traditional quality education they have been providing for many, many years.

Other "Split interest" gifts were affected by IRA '86. Charitable Gift Annuities need to regain the support of Congress.

Your personal assistance and cooperation in preserving the gift annuity as an important giving vehicle for the use by donors to private institutions will be deeply appreciated.

Sincerely,

Mary Declan Browne, S.C.
Director of Planned Giving

MOUNT ST. JOSEPH, OHIO 45051 TELEPHONE (513) 244-4232

COLUMBAN FATHERS
ST. COLUMBANS, NEBRASKA 68056
TELEPHONE (402) 291-1920

JUNE 23, 1987

TITLE FIRST NAME LAST NAME
ADDRESS

DEAR NN,

I AM WRITING AS THE TREASURER OF THE COLUMBAN FATHERS, A CATHOLIC MISSIONARY SOCIETY.

WE ARE DEPENDENT ON DONATIONS FROM OUR BENEFACTORS WHO WISH TO FURTHER THE WORK THAT WE DO IN MANY FOREIGN COUNTRIES. ONE OF THE BEST WAYS WE FIND IS TO USE THE METHOD OF CHARITABLE GIFT ANNUITIES.

PLEASE VOTE TO AMEND THE TECHNICAL CORRECTIONS ACT OF 1987, IN ORDER TO CLARIFY THAT CHARITABLE GIFT ANNUITIES ISSUED BY IRC SEC. 501(c)(3) ORGANIZATIONS ARE NOT "COMMERCIAL-TYPE INSURANCE" UNDER IRC SEC. 501(M).

I WANT TO EMPHASIZE THAT GIFT ANNUITIES ARE USED BECAUSE A BENEFACTOR WANTS TO MAKE A GIFT TO THE COLUMBAN FATHERS TO HELP IN OUR WORK. GIFT ANNUITIES DO NOT COMPETE WITH COMMERCIAL ANNUITIES AND ARE NOT "COMMERCIAL-TYPE INSURANCE." IF THIS LAW IS NOT CLARIFIED IT WOULD DRY UP AN IMPORTANT SOURCE OF FUNDS FOR THE COLUMBAN FATHERS' CHARITABLE ACTIVITIES. SINCE CHARITABLE GIFT ANNUITIES HAVE BEEN USED BY CHARITABLE INSTITUTIONS FOR OVER ONE-HUNDRED YEARS IT SEEMS STRANGE THAT THIS NEW LAW WOULD OVERTURN THIS LONG STANDING METHODOLOGY. FINALLY, FOR THE SMALL DONOR, A CHARITABLE GIFT ANNUITY IS THE EQUIVALENT OF A LARGE DONOR'S CHARITABLE REMAINDER ANNUITY TRUST WHICH IS UNAFFECTED BY IRC SEC. 501(M).

YOUR KIND CONSIDERATION OF THE ABOVE IS GREATLY APPRECIATED.

SINCERELY,

REV. JOHN M. LAGOMARSINO
TREASURER

COPY: COPY

STATEMENT REGARDING S. 1350, THE TECHNICAL CORRECTIONS ACT OF 1987

Hearing Scheduled for July 22, 1987

Presented to: Senate Finance Committee, Subcommittee on Taxation and Debt Management

Honorable Max Baucus, Chairman

Submitted by: The Committee on Gift Annuities, a coalition of over 1,100 religious, educational, social welfare and other institutions exempt under Section 501(c)(3) of the Code.

The National Association for Hospital Development, a coalition of over 1,200 hospitals and health care institutions exempt under Section 501(c)(3) of the Code.

Oral Testimony by: Conrad Teitell, Member, Prerau & Teitell, White Plains, New York

The Council for the Advancement and Support of Education, a coalition of over 2,800 colleges, universities and other educational institutions exempt under Section 501(c)(3) of the Code, joins in this statement.

SUMMARY OF PRINCIPAL POINTS

I. **Technical Clarification Requested.** We believe Congress did not intend that charitable gift annuities be subject to Section 501(m) of the Code. The Technical Corrections Act should clarify that charitable gift annuities meeting the tests of Section 514(c)(5) are not "commercial-type insurance" within the meaning of Section 501(m).

Specifically, we ask that Section 501(m) be amended by deleting "and" appearing at the end of subparagraph (C), changing the period following subparagraph (D) to a comma and adding the word "and" following the comma, and adding a new subparagraph (E) thereto, to read as follows:

"(E) providing charitable gift annuities that meet the tests described in Section 514(c)(5)."

II. What is a charitable gift annuity? A donor irrevocably transfers money or property to a charitable organization that promises to pay the donor and/or another individual (e.g., the donor's spouse) fixed payments for life. The donor makes a sizable charitable contribution because the payments are far smaller than a commercial annuity would yield.

III. Charitable gift annuities have been used for over 100 years as an important way for charities to get modest gifts from individuals who otherwise could not afford to make charitable gifts until death.

IV. Charitable gift annuities are not subject to Section 501(m) because they are not "commercial-type insurance."

V. Charitable gift annuities are already governed by Section 514(c)(5), enacted by Congress in 1969.

VI. Conclusion. Section 501(m) should be clarified to remove needless uncertainty and confusion regarding the tax status of charitable gift annuities.

TESTIMONY

Mr. Chairman and Members of the Committee:

I am Conrad Teitell, a member of the White Plains, New York law firm of Prerau & Teitell, and appear on behalf of:

The Committee on Gift Annuities, a coalition of over 1,100 religious, educational and social welfare institutions and other institutions exempt under Section 501(c)(3) of the Code; and

The National Association for Hospital Development, a coalition of over 1,200 hospitals and health care institutions exempt under Section 501(c)(3).

The Council for the Advancement and Support of Education, a coalition of over 2,800 colleges, universities and other educational institutions exempt under Section 501(c)(3), joins in this testimony.

I. Technical Clarification Requested.

We believe Congress did not intend that charitable gift annuities be subject to Section 501(m) of the Code. The Technical Corrections Act should clarify that charitable gift annuities meeting the tests of Section 514(c)(5) are not "commercial-type insurance" within the meaning of Section 501(m).

Specifically, we ask that Section 501(m) be amended by deleting "and" appearing at the end of subparagraph (C), changing the period following subparagraph (D) to a comma and adding the word "and" following the comma, and adding a new subparagraph (E) thereto, to read as follows:

"(E) providing charitable gift annuities that meet the tests described in Section 514(c)(5)."

Background. The Tax Reform Act of 1986 added new Section 501(m) to the Internal Revenue Code of 1986 to restrict nonprofit organizations from unfairly competing with for-profit insurance companies in the sale of commercial insurance. Under Section 501(m), charitable and social welfare organizations that engage in providing "commercial-type insurance" will either lose their tax exemption or bear the burden of ordinary income tax on income earned through providing that insurance. The issuance of annuity contracts is included in the statute's definition of "insurance."

Traditional charitable gift annuities issued by charitable organizations are not, however, "commercial-type insurance." The Internal Revenue Service has recognized for more than 25 years that a charitable gift annuity is different from a commercial annuity. *See* Rev. Rul. 62-137, 1962-2 C.B. 28. The Internal Revenue Service also recognizes that the excess of the fair market value of gift property over the value of the annuity received from a charity constitutes a charitable contribution. Rev. Rul. 70-15, 1970-1 C.B. 20.

We are concerned that a misinterpretation of the term "commercial-type insurance" would subject gift annuities to new Section 501(m). This potential problem for charities (and the general public that benefits from their activities) should be clarified by the technical amendment suggested above.

II. What is a charitable gift annuity? A donor irrevocably transfers money or property to a charitable organization that promises to make fixed payments to the donor and/or another individual (e.g., the donor's spouse) for life. The donor makes a sizable charitable contribution because the payments are far smaller than the payments the donor could receive from a commercial annuity.

Gift annuities are not commercial in nature. The donor who receives payments under a gift annuity is not motivated to maximize his or her return, but rather to make a charitable gift. Indeed, under the Code, a donor who itemizes is entitled to a charitable contribution deduction equal to the value of the property transferred in excess of the present value of the payments the donor will receive (computed using Treasury tables).

We emphasize, however, that even with the charitable tax deduction (and many individuals who make annuity gifts get no deduction because they are nonitemizers), the donor still receives considerably less overall monetary benefit than a commercial annuity would yield.

Charitable organizations that provide gift annuities do not compete with life insurance companies that sell commercial annuities. Indeed, the person who makes an annuity gift is not even in the market for a commercial annuity. Rather, the donor wants to make a charitable gift and has selected a gift annuity as the method. Had the individual not made an annuity gift to a charity, he or she would not have purchased an annuity from an insurance company.

III. Gift annuities have been used for over 100 years as an important way for charities to get modest gifts from individuals who otherwise could not afford to make charitable gifts until death.

Typically, a prospective donor wishes to benefit a favorite charity, but may not be able to afford to live without at least some of the income from the gift. Therefore, the donor gives cash or property to a charity in return for an annual income stream -- the annuity. The donor, typically a lower- or middle-income individual, is thus able to fulfill his or her charitable desires currently, but retains the right to a portion of the property's income for his or her support.

Without this long-established fund-raising method, many taxpayers would be unable to make modest gifts, and the nation's charities (and the individuals they serve) would suffer.

Wealthier individuals can accomplish exactly the same result by creating a more formal charitable remainder annuity trust. (It is clear that those trusts are not subject to Section 501(m)). Because of the administrative expenses involved in establishing and maintaining a charitable remainder annuity trust, the charitable gift must generally be in the $50,000 - $100,000 range. Thus, the smaller donor makes his or her gift using the charitable gift annuity arrangement. A gift annuity is sometimes referred to as a "poor man's charitable remainder annuity trust."

IV. Charitable gift annuities are not subject to Section 501(m) because they are not "commercial-type insurance."

Individuals who buy insurance from tax-exempt organizations such as Blue Cross/Blue Shield may do so because Blue Cross/Blue Shield's tax exemption enables it to provide health insurance at or below market cost. In contrast, donors who receive gift annuity payments could purchase the same income stream in the market place for a much smaller amount than they have transferred to a charity.

Donors who make annuity gifts do so because they want to make a charitable gift and choose the gift annuity method because it best suits their donative desires and income needs. A charity is not competing for the dollars of an individual who would otherwise be in the market for a commercial annuity.

V. Charitable gift annuities are already governed by Section 514(c)(5), enacted by Congress in 1969.

Background on Section 514(c)(5). Before enactment of the Tax Reform Act of 1969, a small number of tax exempt organizations had engaged in debt-financed acquisitions ("*Clay Brown* type" transactions) that benefited the seller and allowed the tax-exempt purchaser to acquire a business without any investment of its own funds, and thus to immunize itself from any risk of loss. The charity's tax-exempt status enabled it to pay a higher price for the business than other purchasers could afford, thus giving it an unfair competitive advantage over taxable purchasers.

The Treasury Department's study that preceded the Tax Reform Act of 1969 frequently referred to the problem of "unfair competition." The House Ways and Means Committee report on the 1969 Act referred to the need to tax charities "to the extent that they enter into commercial transactions of the market place in direct competition with taxpaying businesses." *See* Treasury Department Study at p. 318; House Committee Report at p. 40 (Statement of Hon. Edward S. Cohen).

In response, Congress added Code Section 514 to tax the unrelated business income produced by exempt organizations' debt-financed property. However, Congress expressly excepted gift annuities from this rule as long as the value of the annuity is less than 90 percent of the contributed property and other tests are met. *See* Code Section 514(c)(5).

If Congress had intended gift annuities to be subject to Section 501(m), it would have repealed Section 514(c)(5). But it did not. Indeed, gift annuities could be taxed twice if both Sections 514 and 501(m) were applicable, a result that Congress could not have intended. The fact that Congress did not even mention -- let alone repeal -- Section 514(c)(5), requires the conclusion that Section 501(m) is inapplicable to charitable gift annuities.

VI. Conclusion: Section 501(m) should be clarified to remove needless uncertainty and confusion regarding the tax status of charitable gift annuities.

A simple, clarifying technical amendment would allow charities to continue to obtain an important source of lower- and middle-class support for worthy causes that benefit our country.

STATEMENT OF THE COLLEGE

CONSTRUCTION LOAN INSURANCE ASSOCIATION

Re: Technical Corrections Act of 1987
Correction for College Construction Loan
Insurance Association ("CLIA")

In October 1986, Congress authorized the creation of a for-profit, private corporation, the College Construction Loan Insurance Association ("CLIA"), to provide financial guarantee insurance, reinsurance and letter of credit support to issuers of educational facilities obligations. In doing so, Congress was responding to an estimated \$30-\$50 billion deficiency in the nation's educational infrastructure by authorizing the creation of an entity whose function would be to provide issuers (primarily non-profit institutions) with a mechanism (insurance) to access the capital markets.

The timing of CLIA's creation in October 1986 post-dated the enactment of the Tax Reform Act. Thus, no provision was made in recodified Section 149(b) of the Code to indicate that CLIA's guarantees are not federal guarantees.

As a result, the status of CLIA's guarantees remains in limbo and CLIA is unable to secure bond counsel's opinion that its guarantee of tax-exempt bonds would not destroy the tax-exempt status of the bonds. As explained below we believe that Congress should exempt CLIA's guarantees under recodified 149(b) and that it should be properly corrected through the Technical Corrections Act of 1987.

I. The Problem

The Tax Reform Act of 1986 denies tax exemption for interest paid on bonds if the payment of the interest is directly or indirectly guaranteed by the federal government or by an instrumentality of the federal government. This provision was originally enacted in the Deficit Reduction Act of 1984 primarily to prevent the proceeds of tax-exempt bonds from being deposited in a federally-insured institution (such as a bank) to guarantee the payment of interest and principal on the bonds. This technique provides a "double" government subsidy to bond purchasers, namely, tax-exempt income and a federally-guaranteed payment of interest and principal. The Tax Reform Act of 1986 correctly denies tax exemption in these cases. As discussed below, however, new Code section 149(b) is drafted in a manner which would have an unintended negative impact on an unrelated financing area.

Legislation authorizing the creation of a private, for-profit corporation, the College Construction Loan Insurance Association ("CLIA"), came about as a result of the Higher Education Amendments of 1986, Pub. L. No. 99-498, 100 Stat, 1268 (codified and amended as 20 U.S.C. §1132f <u>et seq.</u> (1986). CLIA was authorized for the purpose of providing financial guarantee insurance, reinsurance and letter of credit support to obligations issued to finance or refinance the acquisition or construction of educational facilities. CLIA has been incorporated as a private corporation in the District of Columbia. While the Secretary of Education is authorized under the CLIA statute to purchase up to $20,000,000 of CLIA Voting Common Stock in each of the five fiscal years following CLIA's incorporation, the <u>United States has no liability for CLIA's obligations</u>. Further, it is contemplated that the majority of CLIA's common stock will be privately owned. Section 1132f of 20 U.S.C. explicitly provides that CLIA is not an agency or instrumentality of the United States, and section 1132f-6 expressly provides <u>that no obligation which is insured, guaranteed, or otherwise backed by CLIA shall be backed by the full faith and credit of the United States</u>.

In short, CLIA's statute makes it clear the CLIA should not be a "government instrumentality" whose guarantees would deny tax-exempt status to obligations. CLIA has none of the indicia of government status commonly associated with other government instrumentalities. CLIA cannot sell its obligations to or otherwise borrow from the Federal Financing Bank. Under CLIA's legislation, CLIA has no statutory authority to borrow with the

Secretary of Education's guarantee and no authority to require that the Secretary of the Treasury purchase CLIA's debt obligations.

The determination of the tax status of CLIA's guarantees was specifically left to the jurisdiction of the Ways & Means Committee as is indicated in the last sentence of Section 757 of the Act: "[t]his Section shall not affect the determination of whether such obligation is guaranteed for purposes of Federal income taxes." It was intended that the tax status of CLIA guaranteed debt should be addressed not in the CLIA statute, but more properly in the Tax Reform Act. Unfortunately, however, the Tax Reform Act was enacted prior to the time the final CLIA legislation was passed by Congress and no exemption was included in the Tax Reform Act to cover CLIA guaranteed debt. What is essentially the result of a timing problem has prevented bond counsel from opining that CLIA's guarantees are not subject to Section 149(b) of the Internal Revenue Code. And, without such an opinion from bond counsel, CLIA cannot insure tax-exempt obligations.

II. Solution

We believe that the only solution to the CLIA problem is to correct Section 149(b) of the Code to include the exemption for CLIA which we believe would have been included had CLIA been extant at the time the Tax Reform Act was enacted. Therefore,we respectfully request that IRC section 149(b)(3)(A)(i) should be amended to read:

> "(i) any guarantee by the Federal Housing Administration, the Veteran's Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, or the College Construction Loan Insurance Association"

III. Reasons in Support of Technical Correction

The language in the Tax Reform Act of 1986 should be corrected to exempt CLIA's guarantees from the definition of federal guarantees under Section 149(b) of the Code for the following reasons:

1. CLIA's guarantees arenot and were never intended to be "federal" guarantees within the meaning of the Code and the lack of a specific exemption for CLIA guarantees is the result of a timing problem and not the result of any substantive disagreement over the status of CLIA's guarantees.
2. Current law provides clear exemptions for the guarantees of entities much more closely tied to the federal government than CLIA such as FNMA, FHLMC, GNMA and SLMA. Further, these other entities have been formed for purposes other than to provide insurance services, which is not the case with CLIA. As such, the lack of a clear exemption for CLIA guarantees under the Code adversely affects CLIA's basic and only business.
3. The activities of CLIA in connection with tax-exempt financing are consistent with the purposes outlined by the Congress in the legislation which established CLIA and do not conflict with the policy and intent of new Code Section 149(b). Failure to correct what is essentially a legislative oversight will render CLIA unable to insure tax-exempt obligations and thus incapable of fulfilling its legislative mission.

In summary, the CLIA statute makes CLIA's private status very clear, CLIA's activities do not conflict with the general intent of Code Section 149(b), and CLIA should be specifically excluded from Section 149(b) and thus render CLIA able to fulfill its legislative mission. For reasons stated, CLIA should be specifically exempt from the federal guarantee provisions of Code section 149(b).

We would appreciate your addressing this issue. If you have any questions concerning our description of the problem or proposed solution, I encourage you to contact William T. Brack at 659-0702.

STATEMENT
OF
THE COMMITTEE OF ANNUITY INSURERS
ON
S. 1350
THE TECHNICAL CORRECTIONS ACT OF 1987
FOR
HEARINGS HELD BEFORE
THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

JULY 22, 1987

The Committee of Annuity Insurers, a coalition of 26 of the Nation's leading annuity writers, appreciates the opportunity to offer comments on S. 1350, the Technical Corrections Act of 1987. The Committee of Annuity Insurers was formed in 1981 for the purpose of monitoring legislative and regulatory matters impacting the annuity company and the annuity policyholder. Enclosed for your information is a list of the member companies of our group.

Before offering specific comments on S. 1350, we would like to take this opportunity to commend the sponsors of this legislation, Chairman Bentsen and Senator Packwood, and the staff of the Finance Committee and the Joint Committee on Taxation. As introduced, the legislation goes a long way toward answering a number of critical questions on those provisions of the Tax Reform Act of 1986 impacting both nonqualified and qualified annuity contracts. To that end, we are most appreciative.

While we are supportive of the legislation as introduced, we would like to bring to the Subcommittee's attention a number of additional issues which we feel should be addressed in any technical corrections legislation reported from the Committee on Finance. We believe that these proposed amendments are technical in nature and do not in any way alter the substantive provisions of the Tax Reform Act of 1986.

Effective Date of Certain Penalty Tax Changes

In the Tax Reform Act of 1986, Congress made a number of changes to the penalty tax on premature distributions from nonqualified annuity contracts under section 72(q) of the Code. These changes included both an increase in the penalty tax from 5 percent to 10 percent and the elimination or revision of certain exceptions from such tax under the pre-1986 Code.

Before the 1986 Act, distributions made to a beneficiary (or to the estate of the annuitant) on the death of the annuitant were exempt from the penalty tax. However, the pre-1986 Code provided no exception from the penalty tax for distributions made upon the death of the holder even though section 72(s) of the Code required that an annuity contract contain language mandating distributions upon the death of the holder. Section 1826(c) of the 1986 Act corrected this problem by amending section 72(q)(2)(B) so as to provide that, in the case of distributions six months after date of enactment, the penalty tax will not apply to any distribution made on or after the death of the holder or, where the holder is not an individual, the death of the primary annuitant. The amendment deleted, however, the exception in pre-1986 law for distributions made on or after the death of the annuitant.

A problem develops insofar as the effective date of the new rule as a result of this deletion. As noted earlier, the repeal of the old exception for distributions made after the death of the annuitant and the imposition of the new exception for distributions made upon the death of the holder is effective for distributions made after April 22, 1987 (six months after date of enactment). As a result of the change, policyholders who were receiving distributions due to the death of the annuitant prior to April 22, 1987, and were continuing to receive distributions after such date, would be subject to a penalty tax. 1/ For example, assume policyholder A owns an annuity contract in which he is the holder and B is the annuitant. Under the terms of the contract (which was entered into prior to 1986), distributions must begin on the death of the annuitant. In December 1986, B dies. Policyholder A begins receiving benefits under the contract with payments to take place over a 3-year period. Since some of the distributions will be made on or after April 22, 1987, policyholder A will be subject to a 10 percent penalty tax on such distributions. Such a result appears highly inequitable.

In order to remedy this problem, we suggest an amendment to the "effective date" provision of section 1826(c) of the 1986 Act whereby the new exemption (and therefore repeal of the old) would be effective with respect to distributions commencing after April 22, 1987. We believe such an amendment would in no way change the substantive rule and would ensure that the intent of making the change apply prospective only is carried out.

Applicability of Section 72(s) to Structured Settlement Annuities

In 1984, Congress amended section 72 of the Code so as to provide that an annuity contract, to be treated as such for purposes of the Code, must contain language specifying the methods of distribution in the event of the contractholder's death. Under these rules, as set forth in section 72(s) of the Code, the contract must provide that, if the contractholder dies before the annuity starting date, the entire interest will be distributed within 5 years after the date of death of the contractholder, or will be annuitized within one year after the date of death over a period equal to the life of the designated beneficiary (or over a period not exceeding the life expectancy of such beneficiary). In the event that the contractholder dies after the annuity starting date but before the entire interest in the contract has been distributed, the contract must provide that the remaining portion of such interest will be distributed at least as rapidly as the distribution method in effect as of the time of the contractholder's death. In the Tax Reform Act of 1986, Congress clarified the application of these so-called required distribution rules in cases where the contractholder is not an individual. Under section 72(s)(6), if the holder of the contract is not an individual (such as a corporate-owned annuity), the primary annuitant shall be treated as the holder of the contract for purposes of the required distribution rules.

A problem arises, however, as a result of the application of these revised required distribution rules to structured settlement annuities. In the case of structured

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1/ The Tax Reform Act of 1986 provided an exception from the penalty tax for certain distributions commenced as of March 1, 1986. Because of questions regarding the applicability of this exception to nonqualified annuities, section 111A(c)(23) of the Technical Corrections Act makes clear that the changes to the early withdrawal tax do not apply to any distribution under an annuity contract if (1) as of March 1, 1986, payments were being made under such contract pursuant to a written election providing a specific schedule for the distribution of the taxpayer's interest in such contract, and (2) such distribution is made pursuant to such written election. This exception would not be applicable, however, in the above case if the distribution on the death of the annuitant commenced after March 1, 1986.

settlement annuities issued after April 22, 1987 (the effective date of the primary annuitant required distribution rule), if the primary annuitant (i.e., the injured party) dies, the entire interest in such contract must be distributed in accordance with the rules set forth under section 72(s). However, section 130(c) of the Code requires that the stream of payments under a structured settlement annuity must be "fixed and determinable as to amount and time of payment" when the agreement is entered into and, further, requires that the payments under such contract, "cannot be accelerated, deferred, increased, or decreased by the recipient of such payments." As a result, it could be virtually impossible in some situations to comply with the required distribution rules of section 72(s) without violating the terms of the structured settlement contract and thus, section 130 of the Code. However, since section 130 of the Code requires a structured settlement annuity (i.e., a qualified funding asset) to be an "annuity contract", it would appear that failure to include the section 72(s) provision in the structured settlement annuity could mean that such contract would not be eligible for section 130 treatment.

There is no policy reason why such annuities should be subject to the required distribution-at-death rules. The very nature of a structured settlement annuity offers no way in which the payments may be prolonged beyond the originally agreed-to period. Furthermore, there would be neither an opportunity nor a motivation to extend tax deferral for additional periods if section 72(s) were not applicable to structured settlement annuities since such annuities are not subject to tax under section 104 of the Code.

Therefore, it is respectfully requested that the Technical Corrections Act of 1987 be amended so as to provide an exception from the section 72(s) required distribution rules for structured settlement annuities. Such a result could be achieved by adding the following new subparagraph to section 72(s)(5):

> "(D) which is a qualified funding asset (within the meaning of section 130(d), but without regard to whether there is a qualified assignment)."

Treatment of Structured Settlement Annuities and Certain Corporated-Owned Annuities Under Alternative Minimum Tax

Section 72(u) of the Code provides that annuity contracts held by nonnatural persons (such as corporations) will not be treated as annuities for Federal income tax purposes and that the income (or inside build-up) on such contracts as determined under section 72(u)(2) will be taxed currently to the owner. However, Code section 72(u)(3) specifically provides five exceptions to the corporate-owned annuity provisions, including an exception for structured settlement annuities.

In section 701 of the Tax Reform Act of 1986, Congress added to the Code a new corporate alternative minimum tax ("AMT"). In order to ensure that all "profitable" companies would pay some tax on their economic income, Congress included as a preference item in the new AMT a book income adjustment preference for taxable years 1987 through 1989 and an adjusted earnings and profits preference for taxable years after 1989.

New Code section 56(g)(4)(B)(iii) provides that for purposes of calculating the earnings and profits of a corporation under the AMT the income on an annuity policy (i.e., the inside build-up), as determined under new Code section 72(u)(2), is includible in adjusted current earnings. A question has arisen, however, as to the interaction of section 72(u) with the earnings and profits calculation and, in particular, the applicability of section 56(g)(4)(B)(iii) to contracts specifically exempted from the corporate-owned annuity provision under section 72(u)(3).

Although section 56(g)(4)(B)(iii) does not specifically recognize the exceptions from the corporate-owned annuity provision (section 72(u)) for alternative minimum tax purposes, we believe there is no sound policy reason for providing inconsistent treatment.

The treatment of structured settlement annuities under the regular tax and the AMT aptly demonstrates this fact. New section 72(u)(3) excepts a "qualified funding asset" (as defined in section 130(d), and without regard to whether there has been a qualified assignment) from the current taxation of its inside build-up under the regular tax structure. An annuity that is a qualified funding asset is one under which the annuity payments match the payments to the injured party under a structured settlement liability. Because of this matching requirement, by definition, the holder of the contract (be it a structured settlement company or a property and casualty company) <u>does not benefit or profit from holding an annuity contract that is a qualified funding asset</u>.

Since the holder does not derive any economic benefit from the inside build-up on such a contract, it should not be included in the adjusted earnings and profits of the "holder" under the AMT. It is our understanding that including the income under such contracts as a preference item for purposes of the adjusted earnings and profits AMT was done under the mistaken belief that such treatment would conform to the treatment of such contracts under the book income preference item in years 1987 through 1989. However, the inside build-up on such contracts, under generally accepted accounting principles, is not reflected in the book income of the holder of the contract and thus is not included in the book income preference.

After analyzing the exceptions in section 72(u)(3), we believe that all such exceptions should be recognized for corporate alternative minimum tax purposes. For example, for reasons similar to those regarding the exception for a qualified funding asset, the income of an annuity that is purchased by an employer upon termination of a pension plan likewise should not be included in the AMT earnings and profits calculation of that employer.

We urge that an amendment be added to the Technical Corrections Act of 1987 to provide that section 56(g)(4)(B)(iii) will not apply to contracts described in section 72(u)(3).

<u>Exchanges of Corporate-Owned Annuities</u>

Section 72(u) of the Code, as added by the Tax Reform Act of 1986, provides that if an annuity contract is held by a person who is not a natural person (such as a corporation), then the contract is not an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. The provision is effective for <u>contributions</u> to annuity contracts after February 28, 1986.

A question has arisen as to the treatment of a corporate-owned annuity which is received in a tax-free exchange under section 1035 of the Code for a corporate-owned annuity issued prior to March 1, 1986. In order that companies might properly account for such contracts, immediate guidance is needed.

The Committee of Annuity Insurers urges the Committee on Finance to incorporate within the Technical Corrections Act of 1987 an amendment which provides that, in the case of a tax-free exchange under section 1035 of the Code, the replacement contract will retain the character of the contract given up in the exchange for purposes of applying the new corporate-owned annuity rules. Not only is such treatment in accord with the policy behind section 1035 of the Code, it is in keeping with the position taken in 1982 in a similar situation.

In the Tax Equity and Fiscal Responsibility Act of 1982 (the 1982 Act), Congress revised the annuity distribution rules of section 72(e) of the Code to provide, among other things, that amounts received before the annuity starting date would first be viewed as withdrawals of income credited to the contract to the extent of such investment income (a "LIFO" rule). The effective date of these provisions, like the effective date of the corporate-owned annuity provision in the 1986 Act, was geared to the date the investment was made in the contract. Thus, if the investment was allocable to the contract after the specified effective date (i.e., August 13, 1982) such investment was subject to the new LIFO rules. The new rules did not apply, however, to investments made prior to the effective date. In so doing, Congress specifically provided in the Conference Report accompanying the 1982 Act that "a replacement contract obtained in a tax-free exchange of contracts succeeds to the status of the surrendered contract. . . ." 2/

We believe that similar treatment should be accorded a tax-free exchange of a corporate-owned annuity. 3/

* * * * * * * * * *

The Committee of Annuity Insurers is pleased to present its views on the Technical Corrections Act of 1987. We believe that the bill as introduced, along with the additional amendments which we have recommended herein, will provide much needed clarifications to our companies and our policyholders. Therefore, we urge enactment of this proposal at the earliest opportunity.

2/ Rept. No. 97-530, 97th Cong., 2d Sess., at 647.

3/ We acknowledge that when Congress amended section 72 of the Code in 1984 so as to require annuity contracts to contain language specifying the methods of distribution in the event of the holder's death, they subjected the new contract issued in exchange for the pre-effective date contract to the new distribution-at-death rule. However, it should be noted that the effective date of the distribution-at-death rules was for contracts entered into after a specified date. Thus, in contrast to the changes made in 1982 to section 72(e) and in 1986 to section 72(u), investments allocable after the effective date to old contracts were not subjected to the new regime -- only totally new contracts.

COMMITTEE OF ANNUITY INSURERS MEMBER COMPANIES

Aetna Life & Casualty Insurance Company
Allstate Life Insurance Company
American Express Company
American General Life Insurance
American International Group
Anchor National Life Insurance
Capital Holding Corporation
Church Life Insurance Corporation
CIGNA Insurance Companies
Equitable Life Assurance Society of the United States
Family Life Insurance Company
Guardian Life Insurance Company of America
Hartford Life Insurance Company
IDS Life Insurance Company
Integrated Resources Life Companies
Kemper Life Insurance Companies
Keystone Provident Life Insurance Company
Life Insurance Company of the Southwest
Metropolitan Life Security Insurance Companies
Nationwide Life Insurance Companies
New England Mutual Life Insurance Company
New York Life Insurance Company
Reliance Life Companies
Sun Life of Canada
The Manufacturers Life Insurance Company
The Travelers Insurance Companies

July, 1987

COMMONWEALTH of VIRGINIA

Office of the Governor
Richmond 23219

Gerald L. Baliles
Governor

July 13, 1987

The Honorable Lloyd Bentsen
Chairman, United States Senate
Finance Committee
ATTENTION: Ms. Laura Wilcox
205 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

I write to oppose proposals being considered by the Senate Finance Committee to increase the federal excise tax on cigarettes and I am pleased to have the opportunity to submit testimony.

Let me say at the outset that the major reason for my opposition is economic. Tobacco is an important industry in Virginia: an industry that produces jobs, payrolls, taxes, and numerous other benefits to the Commonwealth and its citizens. It is also an industry that is undergoing significant changes and market pressures. Additional tax burdens are not justified.

The tobacco industry indicates that it directly and indirectly supports 145,000 employees in the Commonwealth with an annual payroll of over $3 billion. Any drop in sales of tobacco products is felt in the pocketbook of our small farmers who are already struggling to stay afloat.

The impact is also felt in the Commonwealth's pocketbook where according to industry figures, tax revenues related to tobacco produce more than $300 million annually.

It is clear that increasing the excise tax would be detrimental to Virginia's economy. Such an increase also flies in the face of the 1986 Federal Tax Reform Act that focused on reducing special tax breaks that are enjoyed by a few high income individuals. Instead, these bills would levy more taxes on millions of low and middle income individuals.

For all of these reasons, I urge you to oppose these bills and any others that may be introduced that would increase the federal tax on cigarettes.

With kindest regards, I am

Sincerely,

Gerald L. Baliles

G:kw:10

Concordia College
901 South Eighth Street
Moorhead, MN 56560

July 13, 1987

Ms. Laura Wilcox
US Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

We've been watching with concern the discussion regarding the potential taxation of charitable gift annuities. We would like to ask your assistance in amending the Technical Corrections Act of 1987 (H.R.2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m). It is our understanding that there may be some clarification of this issue in the Technical Corrections Bill to the Tax Reform Act of 1986.

We are concerned that the taxation of charitable gift annuities would reduce significantly this important source of deferred gifts for Concordia College. We have been involved in charitable gift annuities since the early 60s and have found that to be a very appealing option for a number of our constituency that have an interest in supporting the college.

For the smaller donor, the charitable gift annuity is the equivalent of a charitable remainder annuity trust, but allows a much smaller contribution. The charitable remainder annuity trust is unaffected by Section 501(m) according to my information.

The majority of our donors, interested in the gift annuity, are interested in the eventual benefit to the college. Their primary aim is not for the annuity payment, but to be able to retain some of the income while making a substantial deferred gift to the college. Concordia College is a sponsor of the Committee on Gift Annuities and would appreciate your assistance in clarifying the exemption of gift annuities from IRC Section 501(m).

Sincerely,

David Benson

David M. Benson
Assistant Vice President
for Development

dmf2M

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July 17, 1987

The Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
Senate Hart Building Room 703
2nd and C Streets N.E.
Washington, DC 20510

In Re: S. 1350 - Technical Corrections Act of 1987

Dear Mr. Chairman:

We are submitting these comments on behalf of a client to call your attention to a matter that we believe should be considered in the context of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350). For purposes of determining the book income adjustment under the corporate alternative minimum tax (AMT), we have discovered that in situations involving affiliated corporations not filing consolidated tax returns, intercompany dividends can generate more book income than actual dividends paid. We believe that the statute needs to be changed to rectify this inequity.

The Problem

Internal Revenue Code Section 56(f) provides for adjustments to book income for corporations in determining their AMT. Section 56(f)(2)(C) provides the only statutory guidance on the treatment of related corporations. This subsection provides that when consolidated tax returns are filed, adjusted book income of the taxpayer shall take into account items properly allocable to group members included in the return. When an affiliated member is not included in the consolidated return, adjusted book income shall include the dividends received from such affiliated members.

In essence, what the statute contemplates here is one book income calculation for the consolidated return group and separate calculations for affiliated members filing separate returns. The problem that arises under this approach is that dividend payments among affiliated group members that do not file a consolidated tax return are included as a book income adjustment at each level, causing the same dividend payment to be included in the book income of multiple corporations.

In our case, the corporation files a consolidated financial statement but separate tax returns. We have found that in "deconsolidating" the financial statement to compute book income for each separate corporation, dividend payments from a subsidiary to the parent result in a book income adjustment for the parent. If the dividend is paid through another subsidiary, another book income adjustment is created; if dividends are paid through multiple subsidiaries, a book income adjustment is created at each level. This multiple counting creates a penalty for not filing a consolidated tax return that we believe is unwarranted and requires legislative action to correct.

The Proposed Regulations

The Treasury Department's recently proposed regulations regarding the corporate AMT book income adjustment do not resolve this matter. Under Prop. Reg. §1.56-1T(d)(6)(i)(C), if consolidated financial statements are used but separate tax returns are filed, to determine adjusted net book income of the parent corporation and of the subsidiaries, any consolidating eliminating entries attributable to the separate companies must be removed. This means that any consolidating, eliminating entries that were used to eliminate the double counting attributable to intercompany dividends must be "backed-out" in reaching adjusted net book income.

With respect to the subsidiaries, their adjusted net book incomes would reflect dividends received from other related corporations as reported in their separate financial statements (presumably trial balances made available to the parent for consolidation purposes). Prop. Reg. §1.56-1T(c)(5)(i)(C). No adjustments would evidently be permitted to eliminate the double counting of separate company intercompany dividends.

Because no adjustment seems to be allowed under the proposed regulations for dividends paid to affiliated companies not filing consolidated tax returns, income is created for book income addition purposes that has been taxed at another entity level. This effectively creates a penalty for not filing a consolidated tax return.

Illustration

When a consolidated financial statement is "deconsolidated" to determine a book income amount for each subsidiary filing its own Federal income tax return, the potential for double counting is introduced. If not eliminated through adjusting entries, we have found that this problem is exacerbated when intercompany dividend payments are made to the parent through tiers of subsidiaries.

The following example illustrates this problem:

Parent Corporation, a calendar-year corporation, holds a wholly owned subsidiary, X, which in turn is a holding company for the stock of Y, an operating subsidiary. In 1987, Y has $100 of earnings and out of those earnings pays a $100 dividend to X. X in turn pays a $100 dividend to Parent, which distributes the dividend to its shareholders. Parent, X and Y have no other earnings. Parent, X and Y use a consolidated financial statement, but file separate Federal income tax returns.

For AMT purposes, it appears that the 1987 book income additions for Parent, X and Y under IRC §56(f) are computed separately as follows:

Book income addition for Y:

	TAX		BOOKS
Operating Income	$100	Operating Income	$100
Taxable Income	$100	Net Book Income	$100

Y's BOOK INCOME ADDITION TO AMTI $-0-

Book income addition for X:

	TAX		BOOKS
Dividend Income from Y	$100	Dividend Income from Y	$100
Dividends received deduction	(100)		-0-
Taxable Income	$-0-	Net Book income	$100

X's BOOK INCOME ADDITION TO AMTI $50

Book income addition for Parent:

	TAX		BOOKS
Dividend Income from X	$100	Dividend Income from X	$100
Dividends received deduction	(100)		-0-
Taxable Income	$-0-	Net Book Income	$100

PARENT'S BOOK INCOME ADDITION TO AMTI $50

Summary for Parent, X and Y:

	Consolidated Return	Separate Returns
Total Net Book Income	$100	$300
Total Taxable Income	$100	$100
Total Book Income Addition to AMTI	$-0-	$100

If Parent, X and Y had filed a consolidated tax return for 1987, no book income addition would be required because consolidating, eliminating entries on the books would have eliminated any difference between book and tax. Because separate tax returns are filed for Parent, X and Y, book income additions totaling $100 ($50 from X and $50 from Parent) are created, potentially triggering the corporate AMT for X and parent.

Note: If Parent had additional tiers of subsidiaries, each tier would have another $50 book income addition. For example, if three tiers of subsidiaries were involved, book income additions would total $150, an amount in excess of the $100 dividend paid.

Recommendation

Congress intended that the book income addition would compel corporations to pay at least some tax when reporting substantial earnings to the public. In this situation, because a consolidated financial statement is prepared, there are no earnings being reported for book purposes that are not reported for tax purposes as a result of intercompany dividends. There is no question of untaxed income. It is only because the taxpayer files separate tax returns for parent and subsidiaries that a book income addition is created. This rule creates an unwarranted penalty for not filing a consolidated tax return and unfairly penalizes those who cannot file a consolidated return or choose not to do so.

To eliminate the double counting of intercompany dividends in this context, we recommend that the inequity in the book income adjustment for a group of related companies not filing a consolidated income tax return be eliminated by providing a statutory rule for an adjustment to net book income for intercompany dividends paid when a consolidated financial statement is used.

Thank you for your attention to this matter. If you have any further questions, please contact Pamela Pecarich or Sam Starr of National Tax Services at 202/822-4000.

Sincerely,

David T. Wright
National Director of Tax Services

SPS/lp

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TESTIMONY OF DAVID T. WRIGHT
National Director of Tax Services
COOPERS & LYBRAND

On S. 1350, The Technical Corrections Act of 1987

July 22, 1987
Before the
Subcommittee on Taxation and Debt Management
Senate Finance Committee

Mr. Chairman and Members of the Subcommittee, I am David Wright, National Director of Tax Services for Coopers & Lybrand, an international accounting firm with more than 95 offices in the United States alone. I am here today on behalf of my firm to suggest additional matters for your consideration in regard to S. 1350, The Technical Corrections Act of 1987, as well as a few refinements to items included therein. These matters have come to our attention in the course of advising clients on the many intricacies of the Tax Reform Act of 1986 (The Act). Additional issues are likely to be discovered in the months ahead, and thus we hope that the tax writing committees will view the corrections process on this massive Act as an ongoing one.

Estimated Tax Payment Rules for U.S. Citizens Abroad

The Act added Section 6654(j) to The Internal Revenue Code to provide special estimated tax rules for nonresident aliens (Act Sec. 1841). These rules permit estimated tax payments for these taxpayers to be made in three installments, with the first due date on June 15 in the amount of 50% of the estimated tax liability. Subsequent due dates and payments are the same as apply to other taxpayers.

We recommend that this rule's application be extended to U.S. taxpayers residing abroad. These U.S. citizens face the same serious difficulties in receiving and compiling their tax records and calculating their tax liabilities, because they are working and residing abroad, as those faced by foreign individuals. Historically, the Internal Revenue Service has acknowledged this hardship. The regulations under Section 6081 grant these taxpayers an automatic extension, until June 15, for filing their tax returns.

Likewise, the estimated tax regulations under Section 6073 had allowed a similar extension until June 15 for payment of the first estimated tax installment by U.S. citizens abroad. However, Section 6073 was repealed in the 1984 Act as part of a consolidation and simplification of the estimated tax rules along with Sections 6015 and 6153. There was no intent on the part of Congress to change the estimated tax rules for U.S. citizens abroad. Nevertheless, the repeal of Section 6073 threw the status of the regulations into doubt. Since that time, for 1985 and 1986 tax returns, IRS has granted specific relief by allowing a two-month extension for the first estimated tax installment. However, this year, in their Announcement IR 87-50, dated April 9, 1987, the Service indicated that future administrative relief would not be provided. We believe the Service has taken this position not because they have lost sympathy with the plight of these taxpayers, but rather because their statutory authority for granting such relief administratively has been greatly weakened. Now that Congress has addressed a similar problem for non-resident aliens, while ignoring a more compelling need for U.S. citizens residing abroad, the Service must feel on thin ice indeed.

Accordingly, we believe legislative action is necessary to resolve this issue on a permanent basis. Our recommendation to extend Section 6654(j) to U.S. citizens residing abroad will simply insure that these taxpayers are not treated worse than foreign individuals in the United States.

Good faith attempts to meet an April 15 deadline for filing returns and estimated taxes would often fail, given the normal delays in mail delivery, greater complexities in preparing these returns because of foreign tax credits and special computations of such items as moving allowances and housing costs, and other difficulties in receiving tax documents from the United States and finalizing return preparation. Further, there would appear to be no compelling reason to deny this relief to U.S. taxpayers abroad, since 50% of the estimated tax liability would be paid on June 15. We hope the Committee will see fit to grant this relief.

Limitations on Net Operating Losses -- The Role of Old Section 382?

The Technical Corrections Act as introduced attempts to clarify when and to what extent the 1954 Code version of Section 382 ("old Section 382") continues to apply (see Section 106(d)(11) of the bill, page 39 of the Description). This effort is badly needed, but the result so far is less than fully satisfactory.

Section 382 limits the use of certain favorable tax attributes when a change in the beneficial ownership of those items occurs. We understand that the intent of the provision in the technical corrections bill is to clarify that old Section 382 will apply _only_ to transactions that are not covered by new Section 382 _because of_ a transition rule exception or other special treatment. On the other hand, a transaction that is subject to new Section 382 but does not result in a limitation should not be subject to old Section 382 after 1986. If this understanding is correct, it is not clearly communicated either by the statutory language or in the Description of the Technical Corrections Act. This area of the law is one where great uncertainty has existed for quite some time, and we believe, now that Congress has settled upon permanent rules here, every effort should be made to clear up ongoing ambiguities about how these rules should operate.

The Description does not mention the situations in which old Section 382 will not apply and does not express that old Section 382 should apply _exclusively_ in a transition rule situation. The statute is also unclear. The amendment to Section 621(f)(1) of the 1986 Tax Reform Act adds a paragraph (B) on "Termination of Old Section 382," which attempts to clarify the matter but fails because a clearer reference is needed to the ownership changes to which old Section 382 will not apply. Further, the period of continued application of old Section 382, after 1986 until January 1, 1989, should also be clarified.

Illustration: The following will illustrate the type of case not clearly addressed by the Act or the Technical Corrections legislation as introduced.

> Suppose Individual A buys exactly 50% of the stock of L, a loss corporation, from Individual B. It is A's intention to have L change its business in the near future. Under old law (pre-1986 Act), L's NOLs would be completely extinguished (under old Section 382(a)) as a result of this transaction. But under new law (Section 382 as enacted by Section 621 of the 1986 Act), the special limitation on NOL utilization does not apply because A did not buy _over_ 50% of L's stock from B (new Section 382(g)).
>
> Thus, new Section 382 does not present a problem. The question is whether _old_ Section 382(a) might continue to be effective and thereby operate to extinguish L's NOLs; note

that new Section 382 is inapplicable by its terms and not because of an effective date or transitional rule.

We recommend that the intended application of the 1986 Act to this type of case be further clarified.

Treatment of Certain Transferees Under Modified ACRS -- Effective Date Problem

Code Section 168(i)(7)(B) now provides that the rule of prior law permitting a transferee to step into the shoes of the transferor for computing cost recovery deductions no longer applies in the case of a termination of a partnership under Section 708(b)(1)(B) -- terminations that result from a sale or exchange of 50% or more of the partnership interests within a 12-month period. This rule was retroactive to terminations occurring after December 31, 1985 (Act Sec. 1809). The intention was that the new half-year convention rule would apply in such cases to provide both the transferor and the transferee a depreciation allowance for one-half of the year in the year of deemed disposition. However the half-year convention rule does not apply until after December 31, 1986 under the modified ACRS system. Hence, a question has arisen concerning the intended effect of these provisions on depreciation deductions for tax years ending after December 31, 1985 but before January, 1987.

We recommend that this effective date problem be solved by applying the half-year convention rule to these transactions occurring in 1986 or by providing a special rule for 1986 that allocates the allowable depreciation between the original partnership (transferor) and the reformed partnership (the transferee) based on the number of months in the tax year that each held the property.

Full Basis Adjustment on Transition ITC -- A Problem of Application for Transactions Subject to At-Risk Rules

Under new Code Section 49(d), if a partnership or S corporation owns an asset entitled to the transition ITC, the partnership or S corporation must reduce the basis of the asset by the full amount of the credit allowable, whether or not the individual partners or S corporation shareholders are actually allowed to claim the credits on their tax returns. The Technical Corrections Act makes clear that, if such a credit is recaptured, there will be an upward basis adjustment for the amount recaptured and that, if such a credit expires unused at the end of the carryforward period, a deduction will be allowed for 100% of the unused credit (bill Section 102(e), Description page 13).

The essence of the solution provided in the technical corrections bill is that, if all else fails, wait 15 years for the carryforward period to expire and finally a proper adjustment will be made. We believe this solution is inadequate. In cases such as transactions to which the at-risk rules apply to deny the credit to individual investors, the relief provided by the introduced bill is just not timely. A much better solution would be to allow the adjustment when the asset is disposed of.

We recommend that a basis adjustment should be provided for these unused credits when the asset is disposed of. This approach is similar to that under the rules adopted for passive losses and would constitute a much fairer result for affected taxpayers.

Definition of Material Participation for Closely Held High Technology Companies

Section 469(c)(5) includes within the definition of trade or business any activity involving research or experimentation within the meaning of Section 174. Section 469(h)(4) defines material participation for a closely held C corporation or personal service corporation as situations where (i) one or more shareholders holding more than 50% of the stock materially participate, or (ii) the requirements of Code Section 465(c)(7)(C)(i)-(iii) are met. Code Section 465(c)(7)(C)(i)-(iii) in turn imposes a three-part test to define an active business. These tests look to (i) the number of full-time employees in management; (ii) the number of employees performing services for the business; and (iii) whether the amount of deduction attributable to such business and allowable under Section 162 and Section 404 exceeds 15% of the gross income of the business.

Our concern arises because the test under Section 465(c)(7)(C)(iii) does not include research and experimentation expenses under Code Section 174 or start-up expenses under Code Section 195. In developing and bringing to market new products, many high technology and research companies incur significant Section 174 expenses as well as start-up expenses under Section 195; the Section 162 expenses may be minimal during their early years. These companies are, in fact, active businesses, but because of the nature of the expenses incurred, they might fail to satisfy the active business test in Section 465(c)(7)(C)(iii).

We do not believe that Congress intended to so adversely affect high technology start-up ventures under Section 469, particularly not after the effort in the 1986 Tax Reform Act to clarify the treatment of R&E expenses.

We recommend that the technical corrections legislation address this problem by amending Section 469(h)(4)(or Section 465(c)(7)(C)) to include any expenses under Section 174 for research and experimentation, or under Section 195 for start-up expenses, as expenses that qualify under these active business tests, along with Section 162 expenses.

Failure to address this issue will cause some high technology start-up companies to fail the material participation test of Section 469(h)(4). The tax result of such failure would be that taxes would accrue on any interest income earned on the firm's venture capital, even though the firm was not operating at a profit. This would occur because the interest income would be considered portfolio income, while the business and its other expenses would be characterized as a passive activity resulting in passive losses. Many potentially affected companies are presently unaware of this issue because it is the end result of interactions between a number of separate provisions. I have no doubt that you will hear more about this matter as the year progresses.

Conclusion

Mr. Chairman and Members, that concludes my statement. To reiterate, we believe a credible job has been done to date on technical corrections, and we have but a few issues worthy of raising to your attention today. However, I would reiterate that we view the task of perfecting the 1986 Tax Reform Act as necessarily requiring an ongoing process, and we hope that the Committee will adopt this view as well. As we practitioners deal more with specific client questions and fact patterns, we gain more experience with the 1986 Tax Reform Act -- its provisions, its gaps, and its flaws, if you will. I expect that we will be back here next summer with additional recommendations, after we grapple with the new law in a return-preparation environment and as we generally gain more experience with it.

Thank you for your attention to these matters. If you have any questions, please feel free to call on me at 822-4262 or Pamela Pecarich, a partner in our National Tax Services office, at 822-4239.

July 21, 1987

STATEMENT OF THE
COUNCIL FOR INTERNATIONAL EXCHANGE OF SCHOLARS
TO THE COMMITTEE ON FINANCE
IN SUPPORT OF THE TECHNICAL CORRECTIONS ACT OF 1987

Re: Tax Treatment of Scholarship/Fellowship Grants to Visiting Students and Scholars

The Council for International Exchange of Scholars (CIES) is a private, nonprofit organization that works in close cooperation with the United States Information Agency (USIA) in administering the Fulbright Scholar program. In the academic year 1986-87, CIES administered approximately 1,010 grants to American scholars abroad and 990 grants to visiting scholars in the United States. Grants to visiting scholars included approximately 800 research fellowships and 190 teaching fellowships.

CIES has a particularly strong interest in the passage of the proposed Technical Corrections Act of 1987 (S. 1350). The proposed legislation contains a provision (section 101(d)(2) of the bill) relating to the tax treatment of scholarship and fellowship grants to nonresident aliens (amending section 123 of the Tax Reform Act of 1986 (the "1986 Act")). If this provision is not enacted, CIES will have to withhold tax from the grants it disburses to senior Fulbright scholars at a flat 30% rate. In our view, withholding of tax at that rate is clearly excessive. While the amount of net revenues at stake is insignificant, it would cause serious individual hardship to the visiting scholars and widespread damage to our international exchange programs.

In commenting on S. 1350, CIES has two major concerns: (1) to express our appreciation to the staff working on technical corrections for the inclusion of that provision in the proposed legislation and thus to urge its approval by the Senate Finance Committee in the mark-up process; and (2) to propose for the Committee's consideration one minor, substantive amendment to section 101(d)(2) which would have the effect of reducing the rate of withholding on fellowships awarded to visiting lecturers from 30% to 14% under section 1441 of the Internal Revenue Code (the "Code").

I. Section 101(d)(2) of S. 1350

Section 101(d)(2) amends section 123 of the 1986 Act by providing that scholarship or fellowship grants to certain non-resident alien individuals (F-, J-, or M- visaholders) for study, research or training in the United States would qualify for the lower 14% withholding rate under section 1441 of the Code, even though such individuals are not candidates for a degree. Otherwise, such amounts would be subject to the 30% rate generally applicable to items of U.S.-source income paid to nonresidents. In the case of nondegree candidates, availability of the 14% rate would be limited to those who qualified for the lower rate under prior law -- i.e., those receiving grants from an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations (including binational or multi-national Fulbright commissions), or a Federal, state or local government agency.

In repealing the partial exclusion from income formerly available to grants to nondegree candidates under old section 117(b)(2), the 1986 Act inadvertently made such grants subject not only to a 30% withholding rate but also to taxation on a gross basis. Since there is no evidence that Congress, in making such grants fully includible in income, intended to increase the applicable rate of withholding or basis of taxation, a technical correction to the 1986 Act is clearly appropriate and urgently needed. In light of the potential detriment to the Fulbright program, CIES is relieved that the Committee staff recognized the need for a technical correction in this area and included it in the proposed legislation. Accordingly, CIES urges the Senate Finance Committee to adopt the proposed correction in its markup of S. 1350, subject only to the one minor amendment outlined below and described in the attached June 8, 1987 memorandum.

II. A Proposed Amendment to Section 101(d)(2) of S. 1350

At the time CIES and other concerned organizations urged the staff of the Congressional committees to consider a technical correction extending the 14% withholding rate to nondegree candidates' grants, we were not aware that Fulbright grants to visiting lecturers would be subject to a 30% rate if not covered under the proposed correction.1/ Because visiting lecturers who are funded directly by sponsoring educational institutions generally have tax withheld from their income as wages, we assumed that Fulbright visiting lecturers would also be subject to graduated wage withholding under section 3402, a provision which, where applicable, takes precedence over withholding at a flat rate under section 1441. However, upon closer examination, it became apparent to us that Fulbright visiting lecturers probably do not qualify for wage withholding because of the lack of an employer-employee relationship. Thus, they appear to be subject to withholding on their gross income at the flat 30% rate, even though by virtue of sections 864 and 871(b), their fellowship income is ultimately subject to tax at the regular graduated rates on a net income basis.

The attached memorandum (which has previously been provided by our counsel to the staff of the Committee) sets forth several reasons why grants to nonresident alien individuals to teach or lecture in the United States should be included in the proposed technical correction preserving the 14% withholding rate for other nondegree grants: (1) to prevent significant overwithholding of tax; (2) to equalize the tax burdens imposed on foreign and U.S. Fulbright lecturers; and (3) to preserve government-sponsored academic exchange programs at their current funding levels.2/ In addition, there appears to be no tax policy justification for subjecting visiting teaching fellows to an

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1/ The proposed correction was actively supported by a number of groups and agencies involved in international educational exchange, including the National Association for Foreign Student Affairs, the Kellogg Foundation and the U.S. Information Agency.

2/ While our focus in these comments is restricted to provisions presently contained in the introduced technical corrections bill, we believe that the 1986 Act's imposition of excessive tax and withholding burdens upon foreign students and scholars needs ultimately to be addressed by much broader legislative proposals. To that end, we intend to work with the Liaison Group for International Educational Exchange in developing a legislative package to equalize the taxation of foreign scholars and U.S. scholars.

excessive rate of withholding, while providing a reduced rate for visiting scholars engaged in research or other academic pursuits.

In closing, we would like to draw your attention to the fact there is very little, if any, net tax revenue at stake here. First of all, the numbers of affected individuals is extremely small. The Fulbright Scholar Program, as administered by CIES, is the major U.S. grantor of university-level teaching fellowships awarded to foreign individuals. It awards only 150 full teaching fellowships each year. Of that amount, at least half are completely exempt from withholding because the recipient is a resident of a tax treaty country. Second, foreign individuals who are funded directly by U.S. educational institutions will continue to be subject to wage withholding, whether or not the proposed amendment is accepted. Third, since visiting lecturers are ultimately subject to tax at the regular graduated rates, passage of the amendment would simply reduce the amount of overwithholding that would otherwise occur. We hope that the Committee will not view the U.S. Government's need for increased tax revenues as justifying the imposition of an interest-free loan to the Government on grants awarded to foreign visiting lecturers under the Fulbright program.

Cassandra A. Pyle, Executive Director,

Council for International Exchange of Scholars

John Jonas, Esq.
Kathleen M. Nilles, Esq.

Patton, Boggs & Blow

WRITTEN STATEMENT

OF

JAMES A. JOSEPH, PRESIDENT
COUNCIL ON FOUNDATIONS
1828 L STREET, N.W.
WASHINGTON, D.C. 20036

ON

H.R. 2636: THE TECHNICAL CORRECTIONS ACT OF 1987

Submitted To: The Honorable Lloyd Bentsen, Chairman
Committee on Finance
United States Senate

MR. CHAIRMAN, members of the Committee, I am President of the Council on Foundations, a membership organization of over 1050 grantmaking institutions, holding assets in excess of $50 billion. Every one of these endowment dollars is permanently dedicated exclusively to charitable purposes, and as a national organization we are dedicated to assisting our members in managing those funds with care and diligence. Moreover, we seek to assist our members in finding ways within that duty of care to maximize their investment yields and thus provide more funding for charitable causes.

Section 501(c)(25) Organizations

The Tax Reform Act of 1986 created a new possibility for public charities -- including -- foundations to diversify their endowment portfolios by investing in Section 501(c)(25) real estate investment funds. Many members of the Council on Foundations have expressed strong interest in this new opportunity.

UBIT Exception and Section 116(a)(5)

It is our clear understanding of the full legislative history which added Section 501(c)(25) to the code that private foundations and community foundations would be able to join with pension funds in the ownership of real property through this new type of exempt organization. More specifically, foundations -- in so doing -- would not be subject to the unrelated business income tax (UBIT) if the Section 501(c)(25) organization uses debt to acquire its real estate. This exemption from UBIT already applies to pension funds and to certain colleges and universities. Without benefit of this exemption, this new investment opportunity becomes meaningless for foundations.

It is our understanding that Section 116(a)(5) of the Technical Corrections Act would repeal this exemption by subjecting non-university charities that are shareholders of a Section 501(c)(25) corporation to UBIT if the corporation uses debt to acquire or improve its real property.

We would submit that this proposed technical correction would frustrate the ability of public charities and foundations to participate actively in newly created Section 501(c)(25) corporations, and for these reasons we oppose this section of the Technical Corrections Act.

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August 18, 1987

Dear Sirs:

I am writing to strongly urge that two completely nonsubstantive provisions be added to H.R. 2636 and S. 1350, the Technical Corrections Bill of 1986. In two cases, the Tax Reform Act of 1986 (the "1986 Act") made permanent substantive changes to the tax law, but failed to codify these changes in law by making them part of the Internal Revenue Code. I urge that the Technical Corrections Bill amend the Code to incorporate these changes in law, which are presently in effect, in order that taxpayers and their advisors may be made aware of these changes much more readily than if they remained uncodified.

1. Section 1807(a)(7)(D) of the 1986 Act provides, for accounts or funds established after August 16, 1986:

> Nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. If contributions to such an account or fund are not deductible, then the account or fund shall be taxed as a grantor trust.

This provision reverses at least one published revenue ruling. See the May 13, 1987, Blue Book explaining the technical corrections provisions contained in the 1986 Act, at p. 42. Moreover, this provision appears to result in far-reaching changes in the treatment of escrow funds. For example, suppose a buyer of property puts a portion of the purchase price into escrow at the closing, with the seller to receive the escrow plus all earnings thereon when certain contingencies are resolved. It now appears that (1) all earnings on the escrow are taxed currently to the buyer (the "grantor" of the escrow fund), (2) the entire balance in the escrow fund, including earnings, is to be treated by both parties as deferred additional purchase price, and (3) the imputed interest rules of Code §§ 1271-1275 will frequently apply to this deferred purchase price, with the earnings on the escrow being treated as "contingent payments" under those rules.

While the wisdom of this result is debatable, the most important thing is that taxpayers know what the rules are. This provision will be a trap for the unwary if it is not made part of the Code itself.

2. Section 44(b)(3)(A) of the Tax Reform Act of 1984 (the "1984 Act"), as amended by Section 1803(b)(2) of the 1986 Act, provides in substance that (a) notwithstanding any other provision of law, no interest is deductible before the period to which it is properly allocable, and (b) section 483 of the Code "shall be treated as including provisions similar to the provisions of section 1274(b)(3) of such Code". These provisions had originally been adopted as transition rules in the 1984 Act, and only applied before January 1, 1985; the 1986 Act deleted the references to January 1, 1985, giving these provisions permanent effect.

These provisions are clearly important enough to be in the Code.

Sincerely,

Michael L. Schler

Summary of the Testimony of
Jack M. Park
Vice President, Governmental Relations
Crowley Maritime Corporation

Representing a Coalition of Maritime Companies and Associations
before the
Senate Finance Subcommittee
on Taxation and Debt Management
re
H.R. 2636, The Technical Corrections Act of 1987
July 22, 1987

The Tax Reform Act of 1986 reduces the deduction available to employers for the cost of meals provided to employees, as well as other meals considered ordinary and necessary business expenses, from 100% to 80%.

The Technical Corrections Act of 1987, as introduced does not incorporate a change that is necessary to permit meals provided to crews on vessels, to personnel on drilling rigs, and others working at remote sites to be fully deductible.

Such a correction should be included because, inter alia:

- It is a legal requirement to provide meals to merchant seamen.
- As a practical necessity meals must be provided by employers to crews on vessels and to personnel on drilling rigs.
- Meals provided to vessel crews and drilling rig personnel are as essential to doing business as other fully deductible costs.
- 80% deductibility is directly contrary to the purposes of various statutes making it a national policy to enhance the strength and competitiveness of our merchant marine.
- Revenue to the Treasury from the 80% rule would be de minimis.

An amendment to the Technical Corrections Act of 1987 is described in the complete statement submitted by the coalition, which should be adopted.

Good morning, Mr. Chairman and members of this Subcommittee on Taxation and Debt Management.

My name is Jack M. Park, Vice President, Governmental Relations, Crowley Maritime Corporation.

I am representing a large coalition of maritime companies and associations, a coalition encompassing the preponderance of the U.S.-flag merchant marine and drilling rig owners and related service industries. I am speaking today for:

AMERICAN COMMERCIAL BARGE LINE COMPANY (ACBL)

AMERICAN INSTITUTE OF MERCHANT SHIPPING (AIMS)

AMERICAN WATERWAYS OPERATORS, INC. (AWO)

COUNCIL OF AMERICAN FLAG-SHIP OPERATORS (CASO)

CROWLEY MARITIME CORPORATION

INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS (IADC)

INTERNATIONAL ASSOCIATION OF GEOPHYSICAL CONTRACTORS (IAGC)

MATSON NAVIGATION COMPANY

NATIONAL OCEAN INDUSTRIES ASSOCIATION (NOIA)

SEA-LAND CORPORATION

TOTEM OCEAN TRAILER EXPRESS (TOTE)

TRANSPORTATION INSTITUTE (TI)

The Tax Reform Act of 1986 reduces the deduction available to employers for the cost of meals provided to employees, as well as other meals considered ordinary and necessary business expenses, from 100% to 80%. Unfortunately, the IRS is applying this rule to meals being provided to crews of merchant vessels and offshore drilling rigs. Such a broad application of the 80% rule leads to the completely inequitable result that meals provided to such crews are treated just like other "business meals," including the infamous "three martini lunch," and "entertainment."

Meals provided to crews of vessels and drilling rigs are entirely different from other "business meals." They are not extravagant or lavish. They are the furthest thing from "entertainment" as defined in the Internal Revenue Code. And they are an absolutely essential aspect of operating vessels and drilling rigs.

The 100% deductibility of the cost of meals provided to crews of vessels and offshore drilling rigs should therefore be restored. In particular, such full deductibility should be restored because:

- It is a legal requirement to provide meals to merchant seamen. This federal law requirement dates back at least to 1872 and is backed by civil and criminal penalties. Owners and operators of drilling rigs are obligated by contracts to provide meals to crew members;
- As a practical necessity, due to physical isolation, meals must be provided by employers to crews on vessels and drilling rigs;

- The penalty to vessel and drilling rig owners and operators is particularly unfair because meals provided to crews members must be provided at a high cost;
- Provision of meals to crew members of vessels and drilling rigs is just as essential an aspect of doing business as lifejackets for those same crew members which are fully deductible;
- 80% deductibility is directly contrary to the purposes of various statutes making it a national policy to enhance the strength and competitiveness of our merchant marine;
- Meals provided to the crews of vessels and rigs are even more necessary and reasonable than meals exempted under the Tax Reform Act from the 80% deductibility requirement. For example, meals provided by restaurants and caterers to their employees are fully deductible; and,
- Revenue to the Treasury from the 80% rule would be de minimis. It is estimated that less than $15-million would be paid in additional taxes if the 80% rule is applied to meals provided to vessel crews and to personnel on drilling rigs.

The Provision of Meals to Merchant Seamen is a Legal Requirement

U.S. law requires vessel owners and operators to provide meals to their crews which alone makes these meals unique when considering that which the Tax Reform Act was intended to cover.

These statutory requirements that meals be provided to vessel crews are long-standing. At least as early as 1872 vessels with inadequate provisions were considered unseaworthy with serious legal ramifications. Act June 7, 1872, ch. 322, §36, 17 Stat. 269, codified as 46 U.S.C. §10902. As currently codified, the 1872 statute provides that "[a]ny 3 seamen of a vessel may complain that the provisions of food or water for the crew are, at any time, of bad quality, unfit for use, or deficient in quantity." 46 U.S.C. §10902(b)(1). If such complaint is found to have merit by the Coast Guard or local consul, the master of the vessel would be civilly liable. 46 U.S.C. §10902(b).

Later Congress went further and made it a criminal offense to withhold suitable food and nourishment from seamen. Act Dec. 21,1898, ch. 28, §22, 30 Stat. 761, codified as 18 U.S.C. §2191. Section 2191 of title 18 provides:

> Whoever, being the master or officer of a vessel of the United States, on the high seas, or on any other waters within the United States...withholds from the... [crew] suitable food and nourishment,... shall be fined not more than $1,000 or imprisoned not more than five years, or both.

Congress also provided for civil liability for the master or owner for the failure to provide "sufficient quantity of stores to last for a voyage of ordinary duration." Act Dec. 21, 1898, ch. 28, §12, 30 Stat. 758 (codified as 46 U.S.C. §661 until 1983). And Congress mandated in detail what provisions had to be provided at a minimum. Act Dec. 21, 1898, ch. 28, §23, 30 Stat. 762 (codified as 46 U.S.C. §713 until 1983). For example, the following substitutes were some of the ones allowed:

> One pound of flour daily may be substituted for the daily ration of biscuit or fresh bread; two ounces of desiccated vegetables for one pound of potatoes or yams; six ounces of hominy, oatmeal, or cracked wheat, or two ounces of tapioca, for six ounces of rice.

As a result of the revision of Title 46 of the U.S. Code in 1983, Pub. L.No. 98-89, 97 Stat. 100, many of the anachronisms of the previous acts protecting seamen were eliminated, but the legislated mandate that seamen be provided meals remains. Seamen currently employed on vessels involved in foreign and intercoastal voyages "shall be served at least 3 meals a day that total at least 3,100 calories, including adequate water and adequate protein, vitamins, and minerals in accordance with the United States Recommended Daily Allowances." 46 U.S.C. §10303. The same requirement applies to vessels involved in coastwise voyages when a crew is engaged by a shipping commissioner. 46 U.S.C. §10507(b). Most importantly, regardless of the type of voyage, it remains a criminal offense punishable by fine and imprisonment to withhold suitable food and nourishment to seamen, 18 U.S.C. §2191; 46 U.S.C. §11507, and a vessel with insufficient provisions is still considered unseaworthy. 46 U.S.C. §10902.

In this respect these meals are the same as providing lifejackets to the crew, also mandated by law but fully deductible.

Restoring 100% deductibility to meals provided to crews of vessels and drilling rigs is necessary to prevent an unwarranted hardship to two of America's most vital industries. The unique nature of the provision of meals to crew members by those industries should be recognized and distinguished in the Internal Revenue Code.

Proposed Amendment

It is recommended that the following proposed amendment to The Technical Corrections Act of 1987 be adopted:

Paragraph (2) of section 274(n) (relating to exceptions to the 80% limitation on deductibility of business meals) is amended by adding the following new subparagraph:

"(E) such expense related to food and beverages provided to a qualified recipient."

Section 274(n) is further amended by adding new paragraph (4) to read as follows:

"(4) QUALIFIED RECIPIENT - For purposes of paragraph (2) (E), the term "qualified recipient" means any person who receives food and beverages while performing services for an employer either --

(A) aboard a commercial vessel as a crew member or officer;

(B) aboard an oil or gas drilling rig located offshore or in Alaska; or

(C) in a remote location where satisfactory meals are not available on the open market; but only if such food and beverages are furnished in a common area which is --

(i) located, as near as practicable, in the vicinity of the place at which such individual renders services, and

(ii) not available to the public and normally accommodates 10 or more employees."

Technical Explanation of Amendments to Section 274(n)

Section 274(n) provides that, as a general rule, only 80% of the cost of business meals are deductible. Paragraph (2) of section 274(n) contains certain exceptions to this general limitation on the deductibility of business meals. The proposed amendment adds an additional exception to the general rule for meals provided to crew members of commercial vessels, to employees working on certain drilling rigs, and to employees furnishing services at remote locations.

Under the proposed amendment, employers may deduct the full cost of meals provided to persons while they are performing services for an employer either (1) aboard a commercial vessel as a crew member, (2) aboard an oil or gas drilling rig located offshore or in Alaska, or (3) in a geographically remote location. To quality under the third prong of the proposed exception, limitations patterned after those set forth in section 119(c) must be satisfied. Thus, "remoteness" is tested under the amendment by reference to whether satisfactory meals are available on the open market. In addition, the place where the meals are provided must be located near the job site, not be available to the public, and must normally accommodate 10 or more employees.

The Senate Finance Committee
Laura Wilcox, Hearing Clerk
SDOB 205
Washington, DC 20510

Re: Technical Corrections Bill S1350

Sept 2, 1987

Dear Ms. Wilcox,

Please enter into the record this copy of the letter which I have sent to the members of the Finance Committee:

As a working, though yet unpublished, author, I wish to protest the 1986 Tax Reform Act, which unfairly and illogically associate writers with manufacturers of tangible products.
I feel restricting financial realities of the writing profession will inhibit the creation of quality literature, forcing writers to produce only "guaranteed sellers".

I request that the peoples' representatives clarify the Technical Corrections Bill S1350, stating that freelance authors' expenses in researching and writing a book or article not be subject to capitalization rules.

Thank You for your time and consideration on this matter.

Sue DeVore

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CABLE DEWBALAW

July 17, 1987

William J. Wilkins, Esq.
Chief Counsel
Senate Finance Committee
205 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Bill:

On behalf of the Man-Made Fiber Producers Association, I am submitting comments relating to an omission in the Superfund Amendments and Reauthorization Act of 1986 (Public Law 99-499, "SARA"). The Man-Made Fiber Products Association is a trade association representing the manufacturers of more than 90% of the U.S. production of man-made fibers, filaments, and yarns. The needed correction would add three additional substances to the list of taxable substances in Section 4672 of the Internal Revenue Code of 1986 (the "Code").

Section 4672 of the Code lists toxic substances that are subject to tax. Under section 4672(a)(2) of the Code, substances shall be included in this list if taxable chemicals (as defined by Code section 4661) "constitute more than 50 percent of the weight of the materials used to produce such substance." Fifty substances are identified by Section 4672. At least three other qualifying substances, polyester, nylon 66 and polyacrylonitrile, however, were omitted.

Polyester is made primarily from xylene and ethylene, both taxable chemicals under section 4661 of the Code. Similarly, benzene, nitric acid, butadiene and hydrogen cyanide are ingredients used in the production of nylon 66.

William J. Wilkins, Esq.
July 17, 1987
Page 2

The third chemical, polyacrylonitrile is a polymer of acetonitrile which, in turn, is made from propylene and ammonia. As the table below indicates, taxable chemicals comprise a majority of the weight of all three substances.

Substance	Percent of Taxable Chemicals by Weight
Polyester	69%
Nylon 66	70%
Polyacrylonitrile	55%

The inclusion of polyester, nylon and polyacrylonitrile among the list of taxable substances in section 4672 would not only address the technical oversight caused by their omission, but would also fulfill the legislative intent of Congress to prevent U.S. manufacturers from being placed at a competitive disadvantage. In enacting SARA, Congress recognized that taxing toxic raw materials would adversely affect American producers by raising their costs of production. To address this imbalance between U.S. and foreign prices for goods produced from the list of taxable chemicals, a system of import duties and export credits was enacted. The inclusion of polyester, nylon and polyacrylonitrile among the list of taxable substances would restore the balance intended by Congress.

The proposed correction would tax imported polyester, nylon and polyacrylonitrile. In addition, American producers would receive a credit for these products that they export. As a result, a fairer and more balanced competitive position would be secured for U.S. manufacturers if this correction is adopted.

Thank you for this opportunity to comment on the technical corrections legislation. I would be happy to provide you or your staff with any additional material it may need.

Sincerely,

John J. Salmon

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July 22, 1987

William J. Wilkins, Esq.
Chief Counsel
Senate Finance Committee
205 Senate Dirksen Office Building
Washington, DC 20510

Dear Bill:

On Friday July 17, 1987, a proposed amendment to the Technical Corrections Act relating to the Superfund Reauthorization Act of 1986 was submitted on behalf of the Man-Made Fiber Producers Association (See attached). The submission suggests that three substances be added to the list of taxable substances identified in Section 4672 of the Internal Revenue Code. Our submission needs a minor clarification with regard to the substance Nylon.

Nylon 66 was identified as a qualifying substance that was omitted from Section 4672 of the Code. However, nylon 66 is but one of two nylon products that properly should be included in the Code. A second nylon product, Nylon 6, also deserves inclusion in Section 4672 based on its chemical composition.

Nylon 6 is made from benzene, ammonia, hydrogen and oxygen. The taxable chemicals (under Section 4661 of the Code) represent approximately 72% of the weight of nylon and a greater proportion of its value. Thus, in amending Section 4672 of the Code, it would be appropriate to individually identify both nylon 6 and nylon 66 as taxable substances.

Thank you for the opportunity to clarify our comment to the technical corrections legislation. Please contact me if you need further information.

Sincerely,

John J. Salmon

78-959 931

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD

William J. Wilkins, Esq.
Chief Counsel
Committee on Finance
United States Senate
219 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Bill:

I would like to bring to your attention an issue involving the "at-risk" rules of newly-amended Code section 465 that requires clarification as the Congress considers S. 1350, the Technical Corrections Act of 1987.

Generally, the Tax Reform Act of 1986 extended the limitations of the "at-risk" rules of Code section 465 to non-recourse financing secured by real estate. Congress enacted this extension in order to limit the opportunity for overvaluation of real property, and to prevent the transfer of tax benefits arising from real estate activities to taxpayers with little or no real equity in the property. Because non-recourse financing provided by a third party commercial lender does not raise these concerns, Congress created an exception to this new rule for real estate non-recourse financing borrowed from a "qualified person". For purposes of this exception, a "qualified person" is defined as "any person which is actively and regularly engaged in the business of lending money."

Although the situation described below is substantially similar to the types of non-recourse borrowing that Congress excluded from the extension of the at-risk rules, it technically falls outside the qualified person exception. It is recourse borrowing where the concerns underlying the at-risk rules are not implicated.

Frequently, partnerships will obtain traditional real estate financing from institutional lenders such as insurance companies and commercial banks who clearly satisfy the definition of a qualified person. For a variety of non-tax and non-accounting reasons, however, it is often not possible or not desirable for the institutional lender to extend the financing directly to the partnership. For example, some states, such as New York, restrict insurers' ability to make loans to entities other than corporations. See Article 5, Section 81, New York Insurance Law, recodified at, Article 14, Section 1404 (statute enumerates permissible classes of investment for insurance company reserves (e.g., government obligations, corporate obligations, certain preferred stock, etc.)*/ Other states that have imposed similar restrictions on insurance company investments include California, Colorado, Connecticut, Florida, Iowa, Maine, Massachusetts, Minnesota, Pennsylvania and Virginia.

In other cases, partnerships have sought to protect partners against loss in the event of foreclosure where such partners have pledged their promissory notes as collateral. In such cases it is desirable to have an entity other than the partnership incur the indebtedness.

In order to avoid such problems, partnerships will frequently seek to interpose a corporate intermediary in the borrowing transaction. To accomplish this result, the parties will often use a structure similar to the following:

> A partnership will issue and sell its own note and mortgage to a specially-formed corporation that is owned by an unrelated third party (typically the intermediate corporation is owned by a company such as U.S. Corporation Co. or Prentice-Hall Services which provide general corporation services to the public). The intermediate corporation will simultaneously issue and sell its own note--secured by the partnership's note and mortgage--to the institutional lender.

Economically, these loan transactions are of no consequence to the intermediate corporation, and the benefits and burdens run from the institutional lender to the partnership. Despite the economic substance of these related transactions, the partnerships, in form, borrow money from the intermediate corporations which, by the very nature of their special purpose creation, are not "actively and regularly" engaged in the lending business as required by the new amendments to the at-risk rules.

It is readily evident that the source of non-recourse financing in each such transaction is a "qualified person" for purposes of the at-risk rule exception. Unfortunately, because of the structure that is either necessitated by state law regulatory requirements or selected based upon valid non-tax considerations, these transactions currently fall within the general limitations of newly-amended Code section 465.**/ It is clear, however, that the concerns underlying the general extension of the at-risk rules to non-recourse financed real estate are not implicated in the transactions at issue.

I have attached suggested statutory language that would resolve this technical problem by amending the definition of "qualified person" to include intermediate corporations involved in "back to back loan" transactions. This is the equitable result given that the form of the transaction is dictated by non-tax considerations.

Please do not hesitate to call if you have any questions or comments with regard to the above.

Sincerely,

John J. Salmon

Enclosure

*/ In September, 1983, this law was partially amended to permit certain insurers to make loans directly to partnerships.

**/ Although the amendments to the at-risk rules do not apply to partnership interests acquired before January 1, 1987, they do apply to subsequent transfers of such interests even though the property was placed in service at an earlier date.

MODIFICATION OF AT RISK LIMITATION ON REAL PROPERTY

(a) General rule - Section 465(b)(6)(D) is amended by adding at the end thereof the following new clause:

"(iii) Back to Back Loan Transactions - For purposes of clause (i) a corporation shall be treated as actively and regularly engaged in the business of lending money under section 46(c)(8)(D)(iv) if -

(I) such corporation borrows money from one or more 'qualified persons' (as determined without regard to this clause) and simultaneously lends the aggregate principal amount borrowed to another person pursuant to terms such that the aggregate amount periodically receivable with respect to the amount loaned by the corporation is equal to the aggregate amount payable, on or about the same dates, with respect to the amount borrowed by the corporation,

(II) such corporation does not engage in any activities other than those described in subclause (I) above, and

(III) the use of the corporation as an intermediary in the transaction described in subclause (I) does not have as one of its purposes the avoidance of Federal income tax."

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD

William J. Wilkins, Esquire
Chief Counsel and Staff Director
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Re: Technical Corrections Act of 1987 (S. 1350)

Dear Bill:

The following comments are submitted on behalf of the Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF) for consideration by the Committee on Finance with respect to S. 1350, the Technical Corrections Act of 1987. These comments, as described in more detail below, suggest technical corrections concerning several pension issues.

I. Section 1105 of the Tax Reform Act

Section 3121(a)(5)(D) of the Internal Revenue Code (the "Code") defines amounts which are treated as wages and includible in the social security wage base for FICA tax as including any contributions to a 403(b) annuity contract which is made by reason of a salary reduction agreement, whether or not evidenced by a written instrument. Neither section 3121(a)(5)(D) nor the legislative history behind its enactment makes any distinction between mandatory, required or voluntary 403(b) salary reduction contributions. Employers generally treat all 403(b) salary reduction contributions as subject to FICA tax even if such contributions are required under the employer's plan.

Section 402(g) of the Code provides that the total amount of elective deferrals contributed annually on behalf of an employee to all 403(b) annuity contracts is limited to $9,500. Section 402(g)(3)(C) of the Code defines "elective deferral" for purposes of the $9,500 limit as including any employer contribution to purchase a 403(b) annuity contract under a salary reduction agreement within the meaning of section 3121(a)(5)(D).

However, the language contained in both the Conference Report accompanying H.R. 3838 (H.Rept. 99-841, 99th Cong., 2nd Sess., 405, 410 (1986)) (the "Conference Report") and General Explanation of the Tax Reform Act of 1986 (JCS-10-87, 662 (1987)) (the "Bluebook") indicates that mandatory or required 403(b) salary reduction contributions will not be treated as "elective deferrals" for purposes of the $9,500 annual limit.

The conflict between the statutory language and the statement of Congressional intent as reflected in the Conference Report and Bluebook explanations should be resolved . A technical correction to section 402(g)(3)(C) of the Code is recommended to conform the statutory language to the Congressional intent, to provide in (C) that: "Any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)) except that such term shall not include contributions that are required under the employer's plan and that are made by salary reduction as determined under regulations prescribed by the Secretary." (Proposed statutory correction underscored.)

II. S. 1350 (the "bill") contains an inaccurate reference in section 111A(b)(11), which provides that a new paragraph (9) is added at the end of Section 1123(h) of the Tax Reform Act of 1986 (the "Act"). The correct reference to the section of the Act to which a new paragraph (9) will be added should be Section 1122(h).

III. Section 1123(e)(2) of the Act

The bill proposes a technical correction to section 1123(e)(2) of the Act with respect to the 1989 restrictions on distributions attributable to 403(b) "elective deferrals" (as defined in section 402(g) of the Code). That proposed correction appears to include a new grandfathering rule for the 1989 restrictions on distributions by providing that such restrictions shall only apply to distributions from 403(b) annuity contracts which are attributable to assets other than assets held as of the close of the last year beginning before January 1, 1989. Therefore, it appears that the restrictions on distributions attributable to 403(b) elective deferrals do not apply to pre-1989 403(b) elective deferrals, including pre-1989 interest attributable to such elective deferrals. This special rule presents problems in identifying, tracking, and allocating the grandfathered 403(b) elective deferrals and earnings. The proposed technical correction language should be revised to reflect more clearly the 403(b) elective deferrals and the amount of the earnings on those amounts determined as at the close of the last year beginning before January 1, 1989 (i.e., rather than referring to "assets"). Alternatively, the technical correction could provide that the 1989 restrictions do not apply to the value under any 403(b) annuity determined as at the close of the last year beginning before January 1, 1989.

IV. Section 1852 of the Act

Section 1852 of the Act extends the 401(a)(9) qualified plan distribution rules to 403(b) annuities for "benefits accruing after December 31, 1986." There had been some speculation that the proposed technical corrections might either clarify the term "benefits accruing after December 31, 1986" or repeal the grandfathering rule for benefits accrued prior to 1987, thereby extending the qualified plan distribution rules to 403(b) annuities irrespective of when such benefits accrued. However, the bill as introduced does not include either of these provisions.

It is recommended that technical corrections specifically define the term "benefits accruing" for purposes of identifying 403(b) amounts not subject to the qualfied plan required distribution rules. For example, one should be able to determine whether or not benefits accrued prior to

1987 merely mean the accumulation value under the 403(b) annuity as of December 31, 1986.

V. Section 1123 of the Act

It is recommended that a technical correction be sought to Section 1123(a) of the Act concerning the exception to the 10% additional tax under section 72(t)(2)(A)(iv) for lifetime annuities commencing after an employee separates from service to include lifetime annuities which begin under a phased retirement.

A technical correction should also be sought to Section 1123(e)(3) of the Act to extend such exception from the 10% additional tax under section 72(t) to individuals who were in pay status as of March 1, 1986, under an irrevocable election for lifetime annuities but who had not separated from service with the employer as of March 1, 1986.

VI. Sections 1105 and 1117 of the Act

The bill would amend Section 1105 of the Act to provide that income on excess deferrals which are distributed before the applicable April 15 date, including income earned during and after the year to which the deferral relates, is includible in income in the year distributed rather than in the year to which the deferral relates as is currently provided. However, Section 1117(b) of the Reform Act, relating to 401(k) contributions, employer matching contributions and employee contributions, provides that excess contributions (plus earnings) and excess aggregate contributions (plus earnings) that are distributed within 2-1/2 months after the end of the plan year are treated as received and earned by the recipient (i.e., employee) in the taxable year to which the contribution relates, subject to a de minimis exception which was added under the bill.

The bill apparently intends that income on excess deferrals distributed under section 402(g)(2) of the Code will be includible in the recipient's gross income in the year distributed whereas income on excess 401(k) contributions, on excess aggregate contributions as defined in section 401(m) of the Code, or on certain other excess contributions as defined under section 4979 of the Code, will be generally includible in income in the taxable year to which the contribution relates. It is recommended that the rules relating to the taxable year for inclusion in gross income of income allocable to excess deferrals (section 402(g)(2) and income allocable to excess aggregate contributions and excess contributions under section be made consistent. The inclusion of earnings in the year distributed (rather than the year to which the excess contribution relates) is easier to administer and would reflect the fact that a portion of the earnings may in fact have been earned in the year of distribution.

Barbara Seymon-Hirsch of TIAA/CREF would be happy to answer any questions or discuss this matter with your or your staff. She can be reached at (212) 916-4663.

Respectfully submitted,

Dewey, Ballantine, Bushby,
Palmer & Wood

By: Lawrence F. O'Brien
Lawrence F. O'Brien, III

The Diocese of Colorado Springs

29 West Kiowa Street
Colorado Springs, Colorado 80903-1498

Office of Planned Giving
(303) 636-2345

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington D.C. 20510

July 8 1987

Dear Ms. Wilcox:

I am writing concerning a provision under section 501(m) of the Internal Revenue Code. Pertaining to the Tax Reform Act of 1986. I believe firmly that gift annuities issued by non profits should not be taxed or treated like commercial type insurance.

Gift annuities are used because an interested donor wants to make a gift to a non profit institution. The issuance of annuity contracts does not necessarily mean that a gift annuity program rises to the level of "commercial type insurance." I believe they do not since their primary purpose is their intent to make a gift to a charitable institution. Gift annuities have been used in this country for that purpose for almost a century.

I would appreciate your leadership in clarifying that the provision of the Tax Reform Act of 1986 does not apply to charitable gift annuities. This seemed to be the intent behind the Tax Reform Act.

Sincerely,

Jon Calder

Jon Calder
Director of Gift Planning

EAST CAROLINA UNIVERSITY
GREENVILLE, NORTH CAROLINA 27858-4353

Office for Institutional Advancement (919) 757-6685

July 7, 1987

Ms. Laura Wilcox
U. S. Senate Finance Committee
S. D. 205
Washington, DC 20510

RE: POTENTIAL TAXATION OF CHARITABLE GIFT ANNUITIES

Dear Ms. Wilcox:

This letter is to express our concern over the issue of whether charitable gift annuities would become subject to the unrelated business income tax under the new section 501 (m) of the 1986 Tax Reform Act. This new section taxes the commercial insurance activities of nonprofit organizations.

We understand that technical corrections bills covering details of the Tax Reform Act are pending in both the House and Senate, and so far they fail to clarify that charitable gift annuities are <u>not</u> subject to the unrelated business income tax because they are <u>not</u> commercial insurance under section 501(m). Such clarification should be made to specifically exclude charitable gift annuities from the provisions of section 501(m).

Charitable gift annuities, through which a donor may make an immediate gift to a nonprofit organization and receive back a specified income for life, have <u>never</u> been treated as an unrelated trade or business. In 1969, Congress added Tax Code section 514(c) (5) specifically to direct how charitable gift annuities are to be treated under the unrelated business income tax. Though this section was not amended by the Tax Reform Act, the new section 501(m) <u>could</u> be read to include charitable gift annuities.

<u>Donors, typically less wealthy than those who create charitable remainder trusts, use charitable gift annuities because they want to make a gift, not because they want the annuity income.</u>

We respectfully request that the technical corrections bill clarify that charitable gift annuities are <u>not</u> subject to the unrelated business income tax because they are not commercial insurance under section 501(m) of the Tax Reform Act of 1986.

Thank you for considering our concerns and request. Please let me know if I can be of further assistance in this regard.

Sincerely,

Micah D. Ball

Micah D. Ball
Director of Planned Support
and Special Gifts

cc: Dr. Richard R. Eakin, Chancellor
Mr. James L. Lanier, Vice Chancellor for Institutional Advancement
Mr. David B. McDonald, Director of Institutional Advancement
Mr. W. R. Roberson, Jr., President, ECU Foundation, Inc.

East Texas Baptist University

Honorable Dan Rostenkowski
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Representative Rostenkowski:

I write out of concern for the generation-skipping transfer tax provisions under Chapter 13 of the Internal Revenue Code of 1986.

A substantive change has been slipped into the Technical Corrections Bill of 1987 (H.R. 2636 and S. 1350) introduced on June 10, 1987, in both houses of Congress which amends, rather than corrects, Sec. 2646(a)(2)(B) and Sec. 2642 (d)(2)(B) by deleting the language reducing the denominator of the applicable fraction by any charitable deduction allowed under Sec. 2055 or Sec. 2522 with respect to such property. As a result, neither the denominator of the applicable fraction for new trusts nor the denominator of the recomputed applicable fraction for additions to generation-skipping trusts will be reduced by otherwise allowable charitable deductions.

Reference is also made to the new Sec. 2625 which has been added to Chapter 13, and Sec. 2622 which defines "Taxable Amount."

The result of the above changes (not technical corrections of the Tax Reform Act of 1986!) is to completely abolish the savings opportunities in regard to generation-skipping transfer tax which charitable lead trusts provided under the original provisions of the Tax Reform Act of 1986. In addition, the charitable deduction will be available only for the portion of the taxable amount which is actually distributed to charity.

This proposed change is clearly more than a "correction", it is substantive. I read in the Wall Street Journal that you said, "This legislation is not intended or designed to make substantive changes to last year's act. In this regard, the staff has undergone painstaking analysis and review to help insure the technical nature of this legislation. I will, of course, not support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments."

I therefore, urge you to have your staff examine this area of the correction bill and keep the charitable deduction in the generation-skipping transfer tax's "inclusion ratio" formula.

As observed above, to repeal the Generation-Skipping Transfer Tax charitable deduction for lead trusts is clearly substantive and not technical. In addition, I would point out that the change is contrary to congressional policy of encouraging charitable gifts. This change, if enacted, could cost the nations private service sector (hospitals, schools, etc) billions of dollars in years to come.

I urge you to use your influence and position to keep the Technical Corrections Bill of 1987 just what its name implies, and to leave the historical position of the congress intact to encourage charitable gifts to the nations 501(C)(3) institutions.

Respectfully yours,

Harvey D. Lewis

EASTERN COLLEGE
THE EASTERN BAPTIST THEOLOGICAL SEMINARY
ST. DAVIDS, PA 19087 (215) 341-5800

July 14, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I am writing to express my concern about an important omission in the Technical Corrections Bill (S. 1350).

The omission is an amendment to clarify that charitable gift annuities issued by IRC Sec. 50(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

Purchase of a gift annuity from either of the two institutions I represent by one of our friends is not done primarily to receive income. Primary in their mind is the aspect of making a gift to help our two institutions.

For the people with whom I am in contact, who are not in the large donor category, a charitable gift annuity is the equivalent of a charitable remainder annuity trust, which is unaffected by IRC 501(m).

Gift annuities have been used by charitable organizations in excess of 100 years. These gift annuities are not competitive with commercial annuities and are not "commercial-type insurance."

Failure to clarify this law would greatly effect a decrease in an important source of funds for our two organization's charitable activities.

I have written to each member of the Senate Finance Committee and trust that they will amend the Technical Corrections Act to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not subject to IRC Sec. 501(m).

Thank you for bringing this important and significant matter to their attention.

Sincerely,

Wm R. Rueckle

William R. Rueckle
Director of Planned Giving

STATEMENT OF

THE EDISON ELECTRIC INSTITUTE

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

COMMENTS ON S. 1350

THE TECHNICAL CORRECTIONS ACT OF 1987

July 23, 1987

STATEMENT OF

THE EDISON ELECTRIC INSTITUTE

COMMENTS ON S. 1350

THE TECHNICAL CORRECTIONS ACT OF 1987

July 23, 1987

The Edison Electric Institute (EEI) is pleased to comment on H.R. 2636, the Technical Corrections Act of 1987. EEI is the association of the investor-owned electric utilities whose members generate and distribute approximately 75 percent of the nation's electricity.

Under section 211 of the Tax Reform Act of 1986, in the case of periods after December 31, 1985, a taxpayer is required to reduce the basis of property that qualifies for transition relief from the repeal of the regular investment tax credit (ITC) by the full amount of ITC earned with respect to transition property (after application of the phased in 35-percent reduction). See General Explanation of the Tax Reform Act of 1986 (Blue Book), JCS-10-87, pg. 122, May 4, 1987. There exists a problem with respect to ITC which has been given little attention. The problem relates to the 100 percent basis adjustment for ITC and the interrelationship of the 35-percent reduction for credits utilized in 1988 (17.5 percent, 1987) and later years.

For example, assume X Co. acquires property, subject to a transition rule, costing $100 which is placed in service in 1986. The ITC would be $10 and the basis of the property for depreciation purposes would be $90. The credit is utilized by X Co. as part of a carryforward in 1988, but only $6.50 is utilized because of the 35-percent reduction. It is understood that personnel on the staff of the Joint Committee on Taxation are of the view that the $3.50 is not restored to basis in 1988 (or in 1986, by way of an amended return).

This is obviously unfair and should be corrected by a technical amendment because the 100 percent basis adjustment denies the taxpayer deductions for credits in part never realized. The reduction in basis should reflect the amount of ITC actually utilized, after the application of the phased in 35-percent reduction.

We appreciate the opportunity to provide our comments on this important work of the Committee.

Respectfully Submitted,

Ronald D. Clements
Director, Legislative Affairs

SUMMARY OF COMMENTS OF
HENRY J. SPRING, JR. DIRECTOR-PUBLIC AFFAIRS, PITNEY BOWES INC.

U.S. SENATE
COMMITTEE ON FINANCE

RE: THE TECHNICAL CORRECTIONS ACT OF 1987, S.1350
JULY 24, 1987

Pitney Bowes Inc. (PBI) believes that the Technical Corrections Act of 1987, S.1350, should correct the definition of "book income," under the book income preference provision of the Tax Reform Act of 1986, Section 701, so that the profit from intercompany sales within a consolidated tax group (tax entity) are not included within the meaning of such term.

Within the PBI tax entity, PBI sells to its wholly-owned subsidiary, Pitney Bowes Credit Corporation (PBCC), equipment for subsequent lease to PBI customers. PBCC, as such, acts as a marketing vehicle for PBI. PBCC's leases to third parties are true leases in that neither title nor ownership passes in the leased equipment to the lessee, which is unlike other types of transactions where title passes immediately (installment sales methods) or where title passes automatically at the end of the lease term (completed contract method).

For tax purposes, PBCC is included in PBI's consolidated tax return, and the intercompany sale by PBI to PBCC is not recognized pursuant to the intercompany profit elimination rule provided for in Regulations Section 1.1502-13. Accordingly, PBI recognizes income when the equipment in question is depreciated on the books of PBCC. However, for financial accounting purposes, the intercompany sale from PBI to PBCC is treated as a sale at the time of the lease.

The Congressional intent of the book income preference provision is to tax book income to the extent that economic income has been realized and to prevent the avoidance of taxation. PBI contends that the intercompany sale by PBI to PBCC for purposes of leasing by PBCC does not amount to economic income in that the intercompany sale has resulted in no economic significance to the tax entity. PBI further contends that no sale has taken place since title and ownership remains within the consolidated tax group. Under these circumstances, the only economic income or economic significance realized by the tax entity is the rental income which is taxable in the year in which it is received or due from its lessees. Therefore, there is no tax avoidance. In accordance with well-established principles of tax law, PBI should not be taxed in the first year for rental income that will not be received until future tax years.

Therefore, Section 701 of the Tax Reform Act of 1986 should be corrected to define the meaning of book income so that for transactions where possession of goods or equipment passes to a party outside the consolidated tax entity, income would only be recognized the earlier of the time when title passes or cash payments are received or due. This correction will avoid unintended taxation of intercompany sales where such sales result in no economic income from sources outside the tax entity or where they do not result in any economic significance to the tax entity.

Henry J. Spring, Jr.
Director-Public Affairs
Pitney Bowes Inc.
One Elmcroft
Stamford, CT 06926-0790

COMMENTS OF
HENRY J. SPRING, JR. DIRECTOR-PUBLIC AFFAIRS, PITNEY BOWES INC.
U.S. SENATE
COMMITTEE ON FIANCE
RE: THE TECHNICAL CORRECTIONS ACT OF 1987, S.1350
JULY 24, 1987

On behalf of Pitney Bowes Inc. (PBI), I appreciate this opportunity to present our comments in connection with the Technical Corrections Act of 1987, S. 1350. We believe that the Technical Corrections Act of 1987 is the appropriate legislative instrument to provide clarification of a certain provision of the Tax Reform Act of 1986 (Tax Reform Act). The provision at issue is the book income preference, Section 701 of the Tax Reform Act. PBI believes that the application of the book income preference, as it relates to PBI's internal transfers of equipment through intercompany sales for purposes of leasing to third parties, creates results which were unintended by Congress (as set forth in the General Explanation of the Tax Reform Act of 1986) and which are inappropriate and unfair under well-established principles of tax law.

PBI's Business, Subsidiary and Methods of Accounting

In order that the application of the book income provision to PBI be understood, I would like to briefly describe PBI, its relationship with its subsidiary in question, and its methods of accounting.

PBI manufactures and markets in the United States various items of office and business equipment produced by its U.S. Business Systems Division, as well as those produced by other manufacturers. For the purposes of assisting in the marketing of these products, in 1977 PBI formed a wholly-owned subsidiary, now known as Pitney Bowes Credit Corporation (PBCC). PBCC is included in the Federal consolidated tax return filed by PBI. Where PBI's customers wish to lease, as opposed to purchase, PBI equipment, PBI internally transfers, through an intercompany sale, such equipment from its U.S. Business Systems division to PBCC. These intercompany sales by PBI to its wholly-owned subsidiary, PBCC, does not, in fact, represent a sale or transfer to an unrelated third party since, for consolidated tax purposes, PBI and PBCC are essentially one entity. The leases provided by PBCC cover either a 3-, 4-, or 5-year term. Pursuant to the lease provisions, the equipment must be returned by the lessee to PBCC at the end of the lease term. Alternatively, the lessee may elect to renew the lease or purchase the equipment at its fair market value. Therefore, under the basic terms of its true lease agreement, PBCC retains the risks and burdens inherent in ownership of the leased equipment. The arrangement that PBI has through its wholly-owned subsidiary, PBCC, is a rental of equipment to a third party, with no sale or transfer of title occurring outside the consolidated group (taxable entity).

In PBI's accounting for financial purposes, PBCC is treated as an unconsolidated subsidiary. In accordance with Generally Accepted Accounting Principles, PBI reports "sales" to PBCC in the year that the lease is executed. PBI includes in book income the entire income from the sale to PBCC reduced by its inventoried cost. On the separate accounting records of PBCC, the cost of the equipment to PBCC plus the finance charges inherent in the lease are included as a lease receivable.

In PBI's accounting for tax purposes, PBCC is included in the consolidated tax return of PBI. By consolidating PBI and PBCC for tax purposes, income is recognized as if only one entity exists for tax purposes. Under Regulations 1.1502-3, intercompany profit on the intercompany sale from PBI to its subsidiary, PBCC, for purposes of a subsequent lease to a third party, is treated as a non-taxable event for purposes of consolidated tax reporting. The intercompany profit to PBI is then recognized for tax purposes on the consolidated return as the asset is depreciated on the books of PBCC, thereby offsetting PBCC's depreciation claimed so that in consolidation, depreciation is actually based on PBI's cost of the equipment. Income from third parties is then recognized from from lease receipts. The consolidated return thereby reflects actual economic income being subject to tax in the year in which it is received or realized by the tax entity.

However, under the Tax Reform Act, Section 701, book income preference provision, intercompany sales (as distinguished from a sale to a third party), which are recognized as sales for book purposes, are subject to taxation, even though income from the intercompany transaction has not been received from sources outside the tax entity.

Intent, and Application to PBI, of the Book Income Preference

In the General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514), Title VII-Minimum Tax Provisions, Reasons for Changes, the Congressional intent of the book income preference provision may be summarized by the following excerpts:

> Congress concluded that the minimum tax should serve an overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. (Emphasis added.) p. 432
>
> In certain circumstances where income is defined more broadly for financial reporting purposes than for any tax purposes, Congress concluded that financial reporting definitions should apply, in order to prevent the avoidance of taxation by companies that report earnings to regulators, shareholders or creditors. (Emphasis added.) p. 435

The above passages demonstrate that the Congressional intent of the book income provision under the Alternative Minimum Tax provision was to focus on the situation where a tax entity has received economic income but through various tax mechanisms has effectively avoided taxation. The following is a discussion of why this provision is not applicable to the PBI tax entity based upon the Congressional intent of such provision, in that it has neither, in fact, avoided taxation nor deferred tax on real economic income from third parties.

The intercompany sale of equipment by PBI to its wholly-owned subsidiary, PBCC, for subsequent lease by PBCC to third parties, does not represent economic income or result in any economic significance to the tax entity. Income is recognized in any given year only when rentals are received or due PBCC from leases to third parties and is, therefore, fully reported on PBI's consolidated tax return. There is, in fact, no deferral or avoidance of any economic income received from any source outside the tax entity. PBI and PBCC's lease arrangements may be differentiated from other types of transactions which could more appropriately fulfill the intent of the book income provision. Those other transactions include the installment sales and the completed contract methods. Under the installment sales method, title passes to a third party immediately upon sale. Under the completed contract method, payments are made over a period of time, with title passing (or a sale taking place) to a third party automatically at the end of the contract term. In each of these other arrangements, a disposition or sale of an asset to a third party has occurred, whereas with the intercompany sale of equipment by PBI to PBCC for rental by PBCC under a true lease contract, no sale or disposition to a third party has occurred, and according to the contract, title remains with PBCC and, therefore, the asset remains within the consolidated group. Under the installment and completed contract methods, a clear intention exists from the outset that title and ownership shall pass as a part of the transaction. No such intention exists when PBCC rents its equipment to third parties. It may also be said that under the installment sales or completed contract methods, the income from such sales is deferred over the contract term. PBI and PBCC, as a consolidated taxpayer on the other hand, do not defer economic income but report subsequent true lease rental receipts from third parties in the year in which they are earned and/or received. Therefore, the PBI-PBCC lease arrangement is not the intended target of the book income provision (as set forth in the foregoing General Explanation excerpts), as this arrangement does not avoid taxes by deferring recognition of future rental receipts.

Another stated intention of the book income provision was to correct the harm caused to "the perception and reality of fairness." While concern for public perception is a laudable objective, PBI respectfully disagrees with this objective being used as a basis for taxation where it results in unfairness to PBI, under the circumstances above explained. We believe that the application of the book income provision, like any other provision of the tax code, should insure that in any tax year, economic income received by the taxpayer should be subject to tax in that year, and that taxation should not occur at an earlier time. The PBI tax entity pays taxes on income as it is received from sources outside the consolidated tax entity. Generally Accepted Accounting Principles, which treat the intercompany sale of equipment within the tax entity as a sale, have different objectives than the tax code. Consequently, the PBI tax entity, by adhering to those mandatory accounting principles, is, in effect penalized for tax purposes.

In summary, given the nature of the transactions of PBI at issue (intercompany sales within the PBI consolidated tax entity for subsequent lease and not sale to third parties) and the stated intention of Congress under the book income provision above set forth, PBI believes that such provision is technically in error when applied to the intercompany transactions within the PBI tax entity which are recognized as sales for book purposes. This provision should be corrected or book income defined so as to avoid an unintended tax being levied on a transaction which results in no economic significance to the tax entity or where there is no real economic income received from third parties. Defining book income so that it includes income from transactions where possession of goods or equipment passes to an unrelated party only upon the earlier of the time when title passes or cash payments are received or due, Congressional intent may be more accurately reflected.

Again, I appreciate this opportunity to present PBI's comments and will provide any other information the Committee may deem helpful.

LAW OFFICES
GROOM AND NORDBERG

RE: Comments on International Insurance
Tax Aspects of S. 1350

Dear Ms. Wilcox:

This statement concerning S. 1350, The Technical Corrections Act of 1987, is being submitted for the record on behalf of The Equitable Life Assurance Society of the United States, Metropolitan Life Insurance Company and The Prudential Insurance Company of America.

The Tax Reform Act of 1986 ("1986 Act") made extensive changes in the taxation of foreign operations of U.S. insurance companies and their subsidiaries. For the reasons discussed below, certain provisions affecting these operations should be clarified or revised. We respectfully request that our proposals be incorporated into S. 1350.

1. Investment Income Attributable To Same-Country Insurance Should Not Be Subject To Subpart F.

Subpart F of the Code currently taxes certain income of a controlled foreign corporation ("CFC") to the CFC's U.S. shareholders. One component of subpart F income is "insurance income." As defined in section 953 (after amendment by the 1986 Act), insurance income essentially is income attributable to the insuring of risks arising outside the CFC's country of incorporation. Therefore, insurance income does not include income attributable to the insuring of risks arising within the CFC's country of incorporation ("same-country insurance"). Under prior law, also, section 953 did not apply to same-country insurance income, because that section applied only to the insurance of U.S. risks.

Notwithstanding the rules of section 953, the 1986 Act has made a substantial portion of the income attributable to same-country insurance subject to subpart F. Under section 954(c), foreign personal holding company income -- another component of subpart F income -- now includes all investment income derived by an insurance company, even investment income attributable to same-country insurance. Prior law's exceptions for investment income derived on ordinary and necessary reserves and certain surplus were repealed without regard to whether the income is attributable to same-country insurance.

We believe that the 1986 Act change which applies subpart F to investment income attributable to same-country insurance is inappropriate for the following reasons:

- The earning of investment income is an integral part of the business operations of insurance companies. Premiums are received and invested in order to satisfy benefit claims and other insurance expenses incurred by the company. Thus, the various aspects of an insurance policy are an integrated economic transaction, and investment income is properly viewed as a component of insurance income. Accordingly, when investment income is attributable to same-country insurance, this investment income should continue to be excluded from subpart F as is the case for the same-country insurance income under section 953.

- Maintaining this prior law exclusion for investment income would be consistent with the base company concept of subpart F. Under this concept, subpart F is generally applied only to income that is derived from operations outside the CFC's country of incorporation. See section 954(d) and (e), relating to foreign base company sales and services income.

- Allowing deferral for all types of income attributable to same-country insurance would permit U.S.-owned foreign insurance companies to compete abroad under the same tax burdens that apply to non-U.S.-owned foreign insurance companies. Equalizing this competition for foreign markets would benefit U.S. companies seeking to expand abroad and would help reduce U.S. trade and balance of payment problems.

- The exclusion from subpart F of all income attributable to same-country insurance would not be subject to abuse. If risks were reinsured into a tax-haven affiliate, subpart F would apply to eliminate deferral.

Accordingly, S. 1350 should provide that foreign personal holding company income does not include investment income attributable to same-country insurance.

2. If Investment Income Attributable To Same-Country Insurance Is To Be Subject To Subpart F, (i) Deductions Should Be Allowed For Reserves, Benefits, Policyholder Dividends and Other Expenses, and (ii) Deficits Should Be Carried Forward Against Future Subpart F Income.

i. Deductions

Subpart F taxes U.S. shareholders only on the net income of a CFC after allowance of deductions for expenses of the CFC that are properly allocable to its gross subpart F income. Section 954(b)(5). Accordingly, if, notwithstanding the arguments set forth above, the decision is made to apply subpart F to investment income attributable to same-country insurance, the expenses properly allocable to this investment income must be determined and allowed as a deduction.

In applying subpart F, the deductions for benefit payments, reserves, policyholder dividends and other insurance expenses should not be allocated first to premium income of an insurance CFC. Instead, these deductions should be allocated between the company's gross investment income and gross premium income in a manner that is consistent with the contribution these expenses make to the production of both types of income. In many cases, it will be appropriate to allocate these expenses between investment and premium income on a pro rata basis. In some situations, however, a direct tracing or other allocation method may be appropriate.

Only such a pro rata or other allocation of expenses reflects the fact that an insurance company effectively derives both its premiums and investment income in exchange for its provision of insurance, so that costs of providing insurance -- such as reserves and benefit payments -- contribute to the production of both classes of income. Policyholders pay premiums at the beginning of the period covered by the insurance, and the company uses the investment income earned on these premiums, as well as the premiums themselves, to provide the insurance coverage. For this reason, reserves, benefit payments, policyholder dividends and other expenses of providing insurance are a necessary factor in the production of the company's investment income and should be partly allocated thereto. Moreover, the partial allocation of these insurance expenses to investment income is consistent with the proper method of cost allocation for other financial intermediaries. The contrary method of allocating costs of providing insurance only to premium income is conceptually wrong and should be rejected. It is incorrect to assume that reserves, benefit payments, policyholder dividends and other insurance expenses are only costs of producing premium income and not investment income.

Accordingly, S. 1350 should be clarified to provide for allocation of benefit payments, reserves, policyholder dividends and other expenses on a pro rata or other appropriate basis in computing the investment income attributable to same-country insurance that is subject to subpart F.

ii. Deficits

Under section 952(c)(1)(B), the subpart F income of a CFC that a U.S. shareholder must include in income is offset by the shareholder's pro rata share of any "qualified deficit" incurred by the CFC in a prior year. In order to be qualified, a deficit must be attributable to the same "qualified activity" as the income being offset. The term "qualified activity" means any activity giving rise to: foreign base company shipping income; foreign base company oil related income; in the case of a qualified insurance company, insurance income; or, in the case of a qualified financial institution, foreign personal holding company income.

As discussed above, under the 1986 Act, investment income attributable to same-country insurance is included in subpart F, foreign personal holding company income. A CFC engaged in same-country insurance activities may incur a deficit from those activities if the amount of gross investment income is less than the properly allocable deductions.

It is not clear that section 952(c)(1)(B) allows such a deficit incurred in same-country insurance activities to be carried forward. Under section 952(c)(1)(B)(iii)(III), in the case of a qualified insurance company, only a deficit incurred in an activity giving rise to "insurance income" can be carried forward. However, if the section 953 definition of the term "insurance income" applies for this purpose, a deficit incurred in same-country activites can not be carried forward because section 953 excludes same-country insurance. Similarly, under section 952(c)(1)(B)(iii)(IV), in the case of a "qualified financial institution," a deficit incurred in an activity giving rise to foreign personal holding company income can be carried forward. However, it is not clear that this provision applies to an insurance company since section 952(c)(1)(B)(iv) includes in the term "qualified financial institution" only CFCs engaged in a "banking, financing, or similar business."

S. 1350 should clarify that a deficit incurred in same-country insurance activities can be carried forward and applied to offset any future subpart F investment income from these activities. The general rule of section 952(c)(1)(B) is to allow subpart F income generated by an activity to be offset by prior deficits incurred in that same activity. This general rule should apply to same-country insurance activities as it applies to other activities generating subpart F income.

3. Insurance Reserves For Foreign Operations Should Be Computed Based On The Factors Relevant To Those Operations.

For the first time under the 1986 Act, subpart F applies to certain income a CFC derives from insuring foreign risks of unrelated parties. The computation of this subpart F income requires the determination of insurance reserves which are a deduction from the gross income of an insurance CFC.

Reserves are a measure of the present value of a company's insurance liabilities. A deduction for reserves is provided for insurance companies in order to properly reflect their income.

For insurance operations in the United States, the Code generally bases the determination of reserves on interest rate, mortality, morbidity and expense factors derived from U.S. experience. See sections 807 and 846. It would be illogical, however, to use the same U.S. experience factors to determine reserves for foreign operations since U.S. and foreign interest rates and other experience may be very different.

The present value of foreign insurance liabilities cannot be accurately determined if reserves are based on factors derived from U.S. experience. For this reason, the use of U.S. reserve factors would inevitably overstate or understate the income from foreign insurance operations. Accordingly, it should be clarified that reserves for foreign operations are to be based on factors relevant to those operations rather than on U.S. factors.

4. The Fresh Start For Casualty Insurance Reserves Should Be Excluded From Earnings And Profits In Computing Dividends From A Foreign Corporation And The Indirect Foreign Tax Credit.

The 1986 Act substantially revised the method for computing reserves for casualty insurance companies. The Act gave companies a "fresh start," however, for preexisting reserves. Under the fresh start rules of Act section 1023(e)(3), any decrease in these preexisting reserves resulting from the change to the new method for computing reserves is not included in taxable income but is included in earnings and profits.

The increase of earnings and profits by the fresh start is inappropriate for certain purposes in the international context. Unlike the domestic context, in the international context increasing earnings and profits by the fresh start often increases the amount of total corporate level tax (U.S. and foreign) rather than only the amount of individual shareholder level tax on distributions. S. 1350 (section 112(h)(6)) recognizes that such an increase in corporate level tax is contrary to the purpose of the fresh start by providing that the fresh start shall not increase earnings and profits in applying Code section 952(c)(1)(A). The latter provision limits the subpart F income of a CFC to the amount of its earnings and profits.

This rule of S. 1350 should also apply to the determination of whether a distribution by a foreign corporation to a U.S. corporation is a dividend and to the determination of the indirect foreign tax credit under sections 902 and 960 with respect to such a dividend. Under sections 902 and 960, a U.S. shareholder that receives an actual or deemed subpart F dividend from a foreign corporation qualifies for an indirect foreign tax credit equal to a portion of the foreign taxes paid by the foreign corporation. This portion is based on the ratio of the amount of the actual or deemed dividend to the amount of the foreign corporation's earnings and profits.

Increasing earnings and profits for purposes of this indirect foreign tax credit computation or for determining whether a distribution to a corporation is a dividend would produce inappropriate results. The indirect foreign tax credit would be diluted, thereby increasing corporate level tax contrary to the purpose of the credit and the fresh start. For instance, there would be residual (after foreign tax credit) U.S. corporate tax if a U.S. corporate shareholder received an actual or deemed dividend from a foreign casualty insurance company that is subject to an effective rate of foreign tax equal to the U.S. effective rate. It is contrary to the purpose of the indirect foreign tax credit and the fresh start, however, to impose residual tax in this situation. There should be no residual U.S. tax when the United States and a foreign country are taxing income at the same effective rate. Moreover, if the fresh start increases earnings and profits and therefore residual tax, the change in method for computing casualty reserves will also increase corporate level tax with respect to preexisting reserves. This is the very result the fresh start was designed to avoid. The inappropriateness of this result is underscored by the fact that it does not occur if a U.S. casualty company operates in a foreign country through a branch rather than a subsidiary.

Accordingly, S. 1350 should be revised to provide that the fresh start does not increase earnings and profits for purposes of determining whether a distribution to a U.S. corporation is a dividend and of computing the indirect foreign tax credit under sections 902 and 960 with respect to such a dividend. However, earnings and profits would be increased by the fresh start for purposes of determining whether a distribution to an individual is a dividend.

We would welcome the opportunity to work with staff to resolve these issues and will submit additional materials expanding upon the above discussion as appropriate. Please call if you have any questions.

Very truly yours,

Theodore R. Groom

Theodore R. Groom

Daniel Horowitz

Daniel Horowitz

Supplement To Statement

Outline of Statement

1. Investment Income Attributable To Same-Country Insurance Should Not Be Subject To Subpart F.

2. If Investment Income Attributable To Same-Country Insurance Is To Be Subject To Subpart F, (i) Deductions Should Be Allowed For Reserves, Benefits, Policyholder Dividends and Other Expenses, and (ii) Deficits Should Be Carried Forward Against Future Subpart F Income.

3. Insurance Reserves For Foreign Operations Should Be Computed Based On The Factors Relevant To Those Operations.

4. The Fresh Start For Casualty Insurance Reserves Should Be Excluded From Earnings And Profits In Computing Dividends From A Foreign Corporation And The Indirect Foreign Tax Credit.

Submitted on behalf of
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and
The Prudential Insurance Company of America
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COMMENTS ON THE
TECHNICAL CORRECTIONS BILL OF 1987
(H.R. 2636 AND S. 1350)

The ERISA Industry Committee ("ERIC") offers the following comments on the Technical Corrections Bill of 1987 (the "Bill").

1. PAYSOPs.

a. Plan Termination Exception to the 84-Month Rule. The Tax Reform Act of 1986 (the "Act") amended Code section 409(d)(1) to allow distributions upon the termination of a tax-credit ESOP (i.e., a PAYSOP) without regard to the 84-month rule prescribed by section 409(d). The legislative history of the Act makes it clear that this exception to the 84-month rule applies regardless of whether the employer securities held by the ESOP are distributed to plan participants or are transferred to another plan. See, e.g., Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 715, 833-34 (1987) (the "Blue Book"). "Congress saw no purpose in restricting distributions or in otherwise limiting transfers or rollovers to other qualified plans upon plan termination." Id. at 834.

Notwithstanding the clear statement of Congressional intent in the legislative history, section 111B(i)(1) of the Bill would restrict the availability of the plan termination exception to cases in which (i) the distribution to every participant upon the termination of the PAYSOP is a lump-sum distribution and (ii) the employer does not establish a "successor plan" (a term that the Bill does not define).

The "lump-sum" restriction would prevent the plan termination exception from applying in many cases in which it was clearly intended to apply: where the securities are transferred directly to another plan upon the termination of the PAYSOP, where the employer maintains another stock bonus plan (which must be aggregated with the PAYSOP for lump-sum distribution purposes), or where, by design or inadvertence, the ESOP fails to distribute a single participant's account balance in one calendar year. Likewise, the Bill's introduction of the "successor plan" concept could, contrary to Congressional intent, prevent plan assets from being transferred directly to another plan. See Blue Book at 715, 833-34. In addition, according to some members of the Joint Committee staff, the "establishment of a successor plan" provision might prevent the plan termination exception from applying merely because the employer also maintains a pre-existing defined contribution plan (regardless of the fact that the pre-existing plan was "established" before the PAYSOP was terminated).

Since the proposed amendments conflict with the clearly expressed intent of Congress, they should be stricken from the Bill. Instead, the Bill should make clear that, in accordance with the legislative history of the Tax Reform Act, after a PAYSOP has been terminated, the employer securities held by the PAYSOP (or the proceeds realized upon the sale of those securities) may be transferred to another qualified plan and distributed from that plan without regard to the 84-month rule.

b. Participant Consent. Code section 411(a)(11) should be revised to provide that a terminating PAYSOP may distribute its assets to plan participants without first obtaining the consent of each participant.

As a result of the repeal of the PAYSOP credit, many PAYSOPs will be terminating within the next few years. In order to eliminate the cost of administering a dormant plan, many plan sponsors will wish to terminate their PAYSOPs and to distribute the PAYSOP assets to plan participants.

Section 411(a)(11) may prevent a terminating PAYSOP from making a mandatory distribution to any participant whose account balance exceeds $3,500. In view of the rollover opportunity that is available to the participant in these circumstances, and in view of the amendment to the 84-month rule in section 409(d) (which was clearly designed to facilitate plan terminations), a conforming change should be made to section 411(a)(11) (and to the corresponding provisions of ERISA) to permit the liquidation of terminating PAYSOPs.

A similar amendment should also be adopted to facilitate the termination of plans that accepted only qualified voluntary employee contributions. Since the Tax Reform Act eliminates the ability of a plan to accept such contributions in the future, it is appropriate to allow plan sponsors to terminate those plans whose only function was to accept voluntary employee contributions, without being constrained by participant (and spousal) consent requirements.

c. Distributions "in the Case of" Plan Termination. As it is now worded, the second sentence of Code section 409(d) provides that the 84-month restriction on the distribution of employer securities "shall not apply in the case of . . . death, disability, separation from service, or termination of the plan . . ." (emphasis supplied).

We urge that the phrase "in the case of" be deleted and replaced by the word "after" so that the second sentence of section 409(o) would state simply that the 84-month rule "shall not apply after . . . death, disability, separation from service, or termination of the plan" (emphasis supplied). The purpose of this change is to avoid making it necessary to establish a causal relationship between one of the specified events and the distribution in order for the distribution to qualify for the exception to the 84-month rule. This is likely to be a particularly troublesome issue in the case of a termination of a PAYSOP, since post-termination distributions may be made long after the plan has been terminated (especially if, contrary to ERIC's recommendation, participant consent is required in order to make the distribution).

Although it is clear that post-termination distributions should be exempt from the 84-month rule, the phrase "in the case of" might suggest that if there is too long an interval between the termination of the plan and the distribution, the 84-month rule will apply. In order to avoid this unintended and inappropriate reading of the statute, "after" should be substituted for "in the case of."

This amendment will be even more necessary if, contrary to ERIC's recommendation, the amendment to section 409(d) set forth in section 111(i)(1) of the Bill is adopted. Section 111(i)(1) would limit the plan termination exception to distributions "upon the termination of a plan." Since the word "upon" suggests a close proximity in time as well as a causal relationship, "upon" also should be replaced with "after" if this amendment is retained in the Bill.

d. Diversification Requirement. The Tax Reform Act added a new section 401(a)(28) to the Code. Section 401(a)(28) requires ESOPs and PAYSOPs to allow participants to diversify the investments allocated to their accounts as they approach retirement age. Because the diversification requirement imposes an entirely new obligation on employee stock ownership plans, the diversification requirement applies only to securities acquired after December 31, 1986.

It is now apparent that applying the diversification requirement to PAYSOPs makes no sense in light of the repeal of the tax credit for PAYSOP contributions as of the end of the 1986 tax year and in light of the fact that the diversification requirement applies only to securities acquired after December 31, 1986. In the case of a calendar-year taxpayer that maintains a calendar-year PAYSOP, the only securities subject to the diversification requirement would be the securities purchased in 1987 with the employer's contribution for the 1986 year and the securities purchased in 1987 and subsequent years with dividends received by the PAYSOP. If the employer made its 1986 contribution during 1986 or if the plan distributes dividends directly to participants in accordance with Code section 404(k), the diversification requirement has even less applicability.

The purpose of the diversification requirement is to permit a participant who is approaching requirement age to diversify the investment of a "major source" of his retirement savings. "Congress was concerned that employees for whom an ESOP provided a major source of retirement savings could be disadvantaged due to the fact that those savings could be invested exclusively in employer securities." Blue Book at 833 (emphasis supplied). However, the repeal of the PAYSOP tax credit makes it apparent that the securities purchased after 1986 under a PAYSOP will never represent a "major source" of a participant's retirement savings. Moreover, the costs of compliance with the diversification requirement will be substantial; the costs will include the cost of identifying and notifying the affected participants, the cost of processing participants' elections, and the cost of administering the diversification rule in conformity with the 84-month rule (which recognizes an exception only for the bare minimum number of shares that must be distributed in order to comply with the diversification requirement).

The minuscule benefits that the diversification requirement confers on PAYSOP participants clearly do not justify the costs of complying with that requirement. Accordingly, PAYSOPs that do not receive contributions for years after 1986 should be exempted from the diversification requirement.

e. Timing of Distributions. The Tax Reform Act added a new section 409(o) to the Code. Section 409(o) requires a PAYSOP to permit early distributions to participants who separate from service before normal retirement age. Under section 409(o), unless a participant otherwise elects, distribution of the participant's account balance under the plan must commence no later than one year after the close of a plan year (i) in which the participant separates from service by reason of the attainment of normal retirement age under the plan, disability, or death, or (ii) that is the fifth plan year following the plan year in which the participant otherwise separates from service unless the participant is reemployed by the employer before that year. This requirement applies only to distributions attributable to stock acquired after December 31, 1986.

The Bill should clarify the relationship between the early distribution requirements imposed by section 409(o) and the distribution rule prescribed by section 411(a)(11). Generally, under section 411(a)(11), as interpreted by the Service's temporary and proposed regulations, a plan may not begin to distribute a participant's interest in a plan before the earlier of age 62 or the participant's normal retirement age under the plan unless either the participant consents to the distribution or the value of the participant's nonforfeitable interest in the plan does not exceed $3,500. Thus, while section 409(o) appears to require an <u>early</u> distribution of plan benefits unless the participant elects otherwise, section 411(a)(11) appears to direct a <u>delayed</u> distribution of benefits unless the participant elects otherwise. Moreover, while section 411(a)(11) includes an exception where the participant's vested accrued benefit does not exceed $3,500, section 409(o) contains no such exception.

The Joint Committee's description of the Bill indicates that section 409(o) was intended to accelerate the otherwise applicable benefit commencement date. However, neither the Joint Committee's description nor the Bill makes clear that section 409(o) supersedes the provisions of section 411(a)(11). <u>See</u> Staff of Joint Comm. on Taxation, Description of the Technical Corrections Bill of 1987, 100th Cong., 1st Sess. 158-59 (1987).

ERIC recommends that the Bill resolve the conflict between these two provisions. In addition, ERIC urges that, to the extent that section 409(o) supersedes section 411(a)(11), a de minimis rule be adopted, so that PAYSOPs that do not accept employer contributions for years after 1986, will not be subject to the requirements of section 409(o). It makes little sense to apply section 409(o) solely to the stock that is purchased with employer contributions made during 1987 for the 1986 year (as well as to any stock purchased with reinvested dividends after 1986). In these circumstances, section 409(o) would apply only to a very small portion of the plan, while section 411(a)(11) would apply to the vast majority of the stock held by the plan. Accordingly, ERIC recommends that section 409(o) be amended so that it either (i) does not apply to a PAYSOP that does not accept employer contributions for any year after 1987 or (ii) does not apply where the employer securities purchased after 1986 have a value of $3,500 or less.

f. <u>Lump-Sum Distributions</u>. The Bill should clarify that section 409(o) permits a plan to make mandatory lump-sum distributions. As it is now worded, section

409(o)(1)(C) provides that unless the participant elects otherwise, the participant's account balance must be distributed "in substantially equal periodic payments (not less frequently than annually)" over a limited distribution period.

The purpose of this provision -- to encourage accelerated distributions from employee stock ownership plans -- would be advanced by permitting plans to make lump-sum distributions. Moreover, even as the statute is currently worded, a plan could satisfy the periodic payment requirement by making monthly payments during the course of a single taxable year. There is no justification for requiring a plan to go to the trouble of making monthly payments if the plan is able and willing to make a lump-sum distribution.

If section 409(o) were interpreted to require a plan to make periodic distributions over more than one taxable year, section 409(o) would deprive plan participants of the favorable capital gain, averaging, and rollover treatment accorded to lump-sum distributions as well as the favorable treatment given to lump-sum distributions of appreciated employer securities. Since there is no suggestion in either the language or the legislative history of the statute that section 409(o) was intended to have this effect, section 409(o) should be revised to make clear that mandatory lump-sum distributions are permissible.

2. Gift Tax.

Code section 2503(f) should be clarified to provide that a plan participant who does not (with his spouse's consent) waive a survivor benefit that is provided by the plan in accordance with the requirements of the Retirement Equity Act is not deemed, for gift tax purposes, to have made a transfer of property by gift to his spouse at the time when the spouse's right to the survivor benefit becomes irrevocable.

Since the survivor benefits required by the Retirement Equity Act are mandatory and can be waived only with the spouse's consent, the participant does not make a voluntary transfer of property in these circumstances. The gift tax does not apply to involuntary transfers. See Harris v. Commissioner, 340 U.S. 106 (1950); Estate of DiMarco v. Commissioner, 87 T.C. 653 (1986); but see LTR 8708008 (Nov. 21, 1986); LTR 8635031 (June 2, 1986).

This result is consistent with the addition of section 2503(f) to the Code. Section 2503(f) provides that if an individual waives any survivor benefits under the Retirement Equity Act, the waiver will not be treated as a gift.

If a spouse's affirmative waiver of a survivor benefit in favor of another beneficiary is not a gift, then a participant's passive acceptance of the requirements of Federal law is not a gift either. In short, neither the provision nor the waiver of a survivor benefit in accordance with the Retirement Equity Act should be treated as a gift for gift tax purposes.

3. Cash or Deferred Arrangements.

a. Business Dispositions. Section 401(k)(2)(B)(i)(III) and (IV) permits a cash or deferred arrangement to make distributions after a "sale by a corporation" of substantially all of the assets used in a trade or business with respect to an employee who continues employment with the "corporation" acquiring the assets and after a "sale by a corporation" of the corporation's interest in a "subsidiary" with respect to an employee who continues employment with the "subsidiary." Section 111(l)(1) of the Bill transfers these provisions to new Code section 401(k)(10) and appropriately expands the provisions to cover all dispositions and not just sales.

However, section 401(k)(10)(A)(ii) and (iii) should be revised to apply to unincorporated entities as well as to corporations. Since the business disposition provisions were not intended to distinguish between entities that are incorporated and those that are not, clauses (ii) and (iii) should be revised to make clear that they apply to unincorporated entities as well as to corporations.

For purposes of consistency, parallel changes should be made in Code section 409(d)(2) and (3) (pertaining to tax credit employee stock ownership plans).

In addition, in order to permit a pension plan to make distributions in the same circumstances, a parallel provision should be added to Code section 401(a) for pension plans.

b. Contingent Benefit Rule. The Tax Reform Act added a new section 401(k)(4)(A) to the Code to provide that a cash or deferred arrangement will not be qualified if any other benefit provided by the employer (other than a matching contribution) is contingent on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash. The Blue Book states (at p. 642) that the contingent benefit rule is not limited to benefits provided under a qualified plan and that the employer could not condition the availability of health benefits on the employee's making elective deferrals under a cash or deferred arrangement.

The Bill should make clear that the contingent benefit rule does not prevent an employer from adopting a nonqualified "excess plan" that permits plan participants, whose ability to participate in a qualified cash or deferred arrangement has been restricted, either by the $7,000 limit imposed by section 402(g) or by the actual deferral percentage limit imposed by section 401(k), to defer additional compensation under a nonqualified arrangement.

We understand that the contingent benefit rule was designed to prohibit arrangements under which an employee's ability to participate in a qualified defined benefit plan was conditioned on his election to defer under a cash or deferred arrangement. Whatever the validity of that concern, it has no application to a nonqualified excess plan, which receives no tax-favored treatment and whose only purpose is to provide benefits on a nonqualified basis in circumstances where those benefits cannot be provided under a qualified plan. Neither the Tax Reform Act nor its legislative history contains the slightest suggestion that Congress intended to prohibit an employer from maintaining a nonqualified plan that provides those benefits that its qualified cash or deferred arrangement may not provide.

4. Excess Contributions.

Section 111(m)(11) of the Bill would amend Code section 4979(f)(2) to prescribe two rules regarding the taxation of excess contributions and excess aggregate contributions that are distributed within 2½ months after the end of the plan year. The rules provide that if the amount distributed is less than $100, it is treated as earned and received in the year in which it is distributed; on the other hand, if the amount of the distribution is $100 or more, it is treated as earned and received in the prior year. ERIC opposes the de minimis rule for distributions of less than $100.

The proposed de minimis rule would require the employer or plan administrator to distinguish between distributions that qualify for the de minimis rule and those that do not. Distributions of under $100 would be required to be reported on the appropriate form for the current year, while larger distributions would be required to be reported on the appropriate form for the prior year.

Meeting the extremely brief 2½ month deadline is difficult as it is. Requiring employers and plan administrators to take the additional step of distinguishing between small and large distributions will make the process even more difficult and is likely to prevent many plans from meeting the 2½ month deadline.

An appropriate alternative to the de minimis rule might be to require all distributions of excess contributions and excess aggregate contributions to be recognized in the year of distribution, but to require that an additional percentage of the excess (perhaps based on the current IRS interest rate) to be distributed at the same time in order to avoid giving participants an incentive to make excess contributions. Of course, the additional required distribution could not exceed the remaining balance in the participant's account under the plan.

5. Highly Compensated Employees.

Section 111(j)(3)(B) of the Bill amends Code section 414(q) to provide that for purposes of identifying an employer's "highly compensated employees" and for purposes of applying the rules regarding separate lines of business, employees who are nonresident aliens and receive no U.S. source earned income from the employer shall not be treated as employees. This provision appears to be intended to respond to ERIC's earlier request that section 414(q) be amended to provide that nonresident aliens "may be" disregarded for purposes of identifying the employees in the top-paid group. However, ERIC's request was that an employer be permitted to disregard nonresident aliens for this purpose, not that it be required to do so. In certain instances an employer may wish to take nonresident aliens into account for purposes of identifying the employees in its top-paid group. There appears to be no justification for preventing an employer from doing so. Accordingly, ERIC recommends that section 111(j)(3)(B) be revised to make the proposed rule regarding nonresident aliens permissive rather than mandatory.

6. Taxation of Distributions.

a. Basis Recovery - Pre-Annuity-Starting-Date Distributions. Section 1122(c)(3) of the Act generally provides for basis recovery under a pro rata rule in the case of amounts not received as annuities. The rule applies retroactively to distributions made after July 1, 1986. The Conference Report indicates that "a separate account of a defined benefit plan (and the income attributable thereto) are treated as a separate contract for purposes of section 72 and application of the pro rata rule." *See* H.R. Rep. No. 841, *supra*, at II-462. However, in Notice 87-13 (Q&A-13) the Internal Revenue Service took the position that if employee contributions to a defined benefit plan are credited with a stated rate of interest, such employee contributions (and the earnings thereon) are not treated as a separate contract for purposes of section 72(e)(9). As a result of the Service's position, employee contributions to a typical contributory defined benefit plan are not eligible for separate contract treatment, since such plans typically credit employee contributions with a specified rate of interest. Furthermore, although Code section 72(e)(8)(D) establishes a transition rule that exempts pre-1987 employee contributions from the new pro rata rule in the case of a plan that, on May 5, 1986, permitted the withdrawal of employee contributions *before separation from service*, section 72(e)(8)(D) will not provide relief to the participants in typical contributory defined benefit plans that do not permit distributions or withdrawals *until* the participant separates from service.

In view of the retroactive effective date of the new basis recovery rules, and the inapplicability of the section 72(e)(8)(D) transition rule to contributory defined benefit plans, the new rules have a harsh and unanticipated effect on many participants in contributory defined benefit plans who retired between July 1, 1986, and December 31, 1986. Many of these participants elected, in accordance with the terms of their plans, to receive refunds of their prior contributions and the earnings thereon, after they had separated from service, but before their employer-provided pension commenced. Virtually all of these participants made their decisions to withdraw their contributions (and earnings) on the assumption that the withdrawals would be taxed in accordance with prior law. Had they known of the retroactive change in the basis recovery rules, many would never have elected to make a withdrawal; others would have elected to roll over the taxable portion of their withdrawal into an IRA or qualified plan. Under current law, it is too late for these participants to reverse their decisions. The withdrawals have been made, and the 60-day rollover period has expired.

In many cases, the change in the law has a strikingly punitive effect. One of ERIC's members has determined that the increase in the employee's taxable income resulting from the change in the basis recovery rule has more than doubled in a number of instances. The same member has found that the group of employees harmed were primarily employees whose jobs were eliminated during 1986 and that the overwhelming majority of these employees were from the hourly and nonexempt salaried ranks. ERIC believes that these employees have been unjustly and unintentionally harmed by the retroactive application of the basis recovery rules to contributory defined benefit plans.

Section 111A(a)(11) of the Bill provides relief from this unjust result, but only for participants in plans maintained by States. Section 111A(a)(11) adds a new paragraph (9) to section 1122(h) of the Tax Reform Act that applies to a plan maintained by a State that, on May 5, 1986, provided for employee withdrawals of employee contributions in a form other than an annuity. Under the Bill, pre-annuity-starting-date distributions from such a plan are subject to the Act's new basis recovery provisions only to the extent that the amount distributed exceeds the employee's basis under the plan as of December 31, 1986. In addition, for this purpose, amounts received (other than as an annuity) before or with the first annuity payment are treated as having been received before the annuity starting date.

However, while section 111A(a)(11) eliminates the punitive effects of the Act's retroactive change in the basis recovery rules for State employees, it does nothing to alleviate the harsh results for employees in the private sector. There is no justification for such discrimination against private sector employees, particularly in the context of a Tax Reform Act that sought to add greater equity to the income tax system.

Accordingly, section 111A(a)(11) should be amended to eliminate completely the harsh effects of the retroactive change in the basis recovery rules and to provide equal treatment to public-sector and private-sector employees.

b. Basis Recovery - Annuity Refund Feature. Section 72(c)(2) of the Code (both before and after the Act) provides for a reduction in the investment in the contract equal to the discounted value of any refund feature provided under the contract. ERIC recommends that section 72(c)(2) be repealed.

Prior to the enactment of new Code section 72(b)(2) -- which limits basis recovery under the exclusion-ratio method to the taxpayer's unrecovered investment in the contract -- there might have been some logic to the reduction required by section 72(c)(2); since it was possible that the taxpayer could recover more than 100 percent of his investment in the contract by outliving his life expectancy, it might have been appropriate to reduce his investment in the contract to reflect the offsetting possibility that the taxpayer might die prematurely and that his investment in the contract would be recovered in the refund to the beneficiary pursuant to section 72(e)(5)(E).

With the enactment of section 72(b)(2), there is no longer any possibility that the taxpayer will recover more than 100 percent of his investment. Accordingly, there is no longer any justification for making the adjustment required by section 72(c)(2). Moreover, if section 72(c)(2) is not repealed, it will effectively preclude full recovery of the taxpayer's investment in the contract except in the case where his premature death results in the payment of a refund. Moreover, the adjustment required by section 72(c)(2) is extremely complex and can be made only by an actuary or someone trained in higher mathematics. See Treas. Reg. § 1.72-7(c)(1). The repeal of section 72(c)(2) would thus advance the Tax Reform Act's objective of simplifying the Code.

c. Small Distributions. Section 72(t)(2) should be revised to provide that the tax on early distributions does not apply to a participant to whom a plan makes a lump-sum distribution of $3,500 or less following the participant's separation from service. Although the literal language of the statute does not now include such an exception, the Conference Report indicates that the conferees intended to create this exception. See H.R. Rep. No. 841, supra, at II-456.

ERIC understands that at least some members of the staff believe that the current provisions of the bill are correct and that it is the Conference Report that is in error. This view is reflected in section 111A(c)(13) of the Bill, which provides that the tax on early distributions applies to involuntary cash-outs.

However, ERIC believes that it is appropriate to exempt small distributions from the section 72(t) tax. Although the recipient of a large taxable distribution can roll over the distribution and therefore avoid the additional tax, many IRA sponsors are unwilling to accept small deposits. Accordingly, ERIC believes that it is appropriate to establish an exception for small distributions. Since Congress has previously recognized $3,500 as the appropriate ceiling for small distributions, ERIC urges that, in the interests of simplicity and consistency, $3,500 should be the cutoff point under section 72(t) as well.

d. Net Unrealized Appreciation. As amended by the Tax Reform Act, Code section 402(e)(4)(J) permits a taxpayer to elect not to have section 402(e)(4)(J) apply with respect to a distribution of appreciated employer securities. By making this election, a taxpayer may recognize all of the income attributable to the appreciated employer securities and to forego the exclusion that is otherwise available for the net unrealized appreciation attributable to those securities.

Section 111A(b)(7) of the Bill corrects two technical errors that appear in Code section 402(e)(4)(J) by changing the phrase "this paragraph" to "this subparagraph" and by allowing the taxpayer to make the election on the tax return in which the distribution is required to be included in gross income if the election is made.

However, an additional technical error in section 402(e)(4)(J) also requires correction. Section 402(e)(4)(J) should be revised to provide that the taxpayer may elect to have this subparagraph and the second and third sentences of section 402(a)(1) apply to the distribution. The second and third sentences of section 402(a)(1) would otherwise require a portion of the net unrealized appreciation to be excluded from the taxpayer's gross income -- contrary to the purpose of the election offered by section 402(e)(4)(J).

e. Section 1124 Election. Section 1124 of the Act and section 402(e)(4)(B) of the Code should be clarified to provide that an election under section 1124 to treat a 1987 lump-sum distribution as though it had been received in 1986 will not be treated as an election made under section 402(e)(4)(B) after December 31, 1986.

The purpose of section 1124 is to permit an employee who separated from service or became disabled before 1987, but who did not receive his lump-sum distribution until 1987, to treat the distribution as though he had received it in 1986. Section 1124 reflects the Congressional judgment that the employee in these circumstances should not be adversely affected by the Tax Reform Act merely because of the delay in distributing a lump-sum distribution following his separation from service. As a result, Congress could not have intended that an election under section 1124 would be treated as a post-1986 election for purposes of section 402(e)(4)(B), since such treatment would thwart the clear objectives of section 1124.

In Notice 87-13 (Q&A-24), the Internal Revenue Service took the position that an election under section 1124 would be treated as a post-1986 election under section 402(e)(4)(B). The Bill should make clear that the Service's position is erroneous.

Section 111A(d)(3) of the Bill adds a new section 1124(c) to provide, in part, that for purposes of section 1124, the term "lump-sum distribution" has the meaning given to that term by Code section 402(e)(4)(A), without regard to section 402(e)(4)(B) (which contains the election requirement). The Bill should clarify that, as a result of this provision, a taxpayer who has made a section 1124 election will not be barred from making an election in the future under section 402(e)(4)(B).

f. Excise Tax on Excess Distributions. Section 111A(g)(5) of the Bill would add a new paragraph (5) to Code section 4980A(d) to permit a spouse who is the beneficiary of all of the interests in a deceased employee's retirement plans to elect (i) not to have the special additional estate tax apply and (ii) to have all of the distributions received by the spouse in respect of the deceased employee aggregated with the spouse's own distributions for purposes of applying the general excise tax on excess distributions.

ERIC recommends a technical correction to this rule. Many individuals, fearing their spouse's improvidence, make their retirement benefits payable to trusts for the benefit of their spouses. This common estate planning technique was recognized and accommodated in Code section 401(a)(9)(B)(iii)(I), which recognizes that payments may be made, for the life of a beneficiary, to or "for the benefit of" the beneficiary. A similar provision should be added to section 4980A(d)(5) to permit the election to be made if the spouse and/or trusts for the benefit of the spouse are the beneficiaries of all of the interests in the deceased employee's retirement plans.

g. Additional Estate Tax. Unless a technical correction is made, the additional estate tax imposed by section 4980A(d) may be erroneously applied twice to the same distribution. This result occurs because the tax applies to "the value of the individual's interests in qualified employer plans and individual retirement plans as of the date of the decedent's death." As a result, if, for example, a participant's spouse is the beneficiary of the participant's plan benefits and delays receiving a distribution from the plan or rolls over a distribution into an individual retirement account (and the spouse does not make the election described in the two preceding paragraphs), the additional estate tax could be imposed both at the time of the participant's death and again at the time of the spouse's death. Since section 4980A is clearly designed to impose the additional tax once and only once, the Bill should correct this technical error in section 4980A(d).

7. Integration.

a. Career Average Plans. Code section 401(l)(4)(C)(i) should be revised to permit a career av ,e plan to use an integration level exceeding covered compensation.

Section 401(l)(4)(C)(i) requires the Treasury to reduce the 3/4 percentage factor used in calculating the maximum excess allowance (or the maximum offset allowance in the case of an offset plan) where an excess plan has an integration level exceeding covered compensation (or with respect to any participant in an offset plan who has final average compensation exceeding covered compensation). Section 405(l)(5)(E)(i) defines "covered compensation" as "the average of the contribution and benefit bases in effect under section 230 of the Social Security Act for each year in the 35-year period ending with the year in which the employee attains age 65."

If it is appropriate to limit the integration factor for a final average plan by reference to "covered compensation," it is inappropriate to limit the integration factor for a career average plan by reference to "covered compensation." In the case of the final average plan, all of the participant's pension benefit is based on the participant's final earnings. In the case of a career average plan where each year's earnings count toward the participant's benefit, the integration levels for the earlier years' earnings might be at very low levels reflecting the social security compensation and benefit levels in effect in those years, while the later years' earnings would typically be at higher integration levels, reflecting the social security compensation and benefit levels in effect in those years. If the integration level used for each year under a career average plan is limited to the then current 35-year average of the social security compensation and benefit bases, the Act would impose a much more restrictive limit on integration for career average plans than for final average plans. Contrary to the assertion in the Blue Book (at p. 697), we believe that Congress did not intend any such result. Accordingly, we recommend that section 401(l)(4)(C)(i) be amended by adding the following:

> "No reduction shall be made pursuant to this clause (i) if benefits are based on the participant's earnings in each year of participation, and the integration level with respect to each year does not exceed the limitation described in paragraph (5)(A)(ii) for each such year."

A career average plan with an integration level with respect to compensation for each year equal to the compensation and benefit base under social security then in effect would produce an ultimate level of integration comparable to that of a final average pay plan with "covered compensation" as the integration level, since covered compensation would represent the average of the social security bases over a 35-year period. Accordingly, the Code should be revised to reflect our recommendation.

b. Simplification of Reduction in Maximum Allowances. Code section 401(l)(5)(F)(i) should be revised to simplify the required reductions in the maximum excess and offset allowances.

Section 401(l)(5)(F)(i) instructs the Treasury to prescribe rules for reducing the maximum excess allowance and the maximum offset allowance in the case of a defined benefit plan that provides for unreduced benefits commencing before the social security retirement age as defined in section 415(b)(8). Since there are three different retirement ages under social security (65, 66, and 67), depending on the employee's date of birth, there would have to be three sets of benefit formulae under the plan in order to reflect the reductions for employees in the three age groups.

To implement Congress' stated goal of simplifying the integration rules, we recommend that section 401(l)(5)(F)(i) be amended by striking the words "the social security retirement age (as defined in section 415(b)(8))" and inserting in lieu thereof the words "age 65." Congress considered it appropriate to use age 65, rather than social security retirement age, for purposes of calculating "covered compensation" (see Code section 401(l)(5)(E)); and we know of no policy reason why age 65 should not also be used in reducing the maximum allowances to reflect unreduced early retirement benefits.

ERIC opposes section 111(g)(3) of the Bill, which would amend Code section 401(l)(5)(E) by substituting "social security retirement age" for "age 65" for purposes of calculating "covered compensation." This change would further complicate the calculation of "covered compensation" and would interfere with the goal of simplifying the integration rules.

8. Title-Holding Companies.

The Tax Reform Act added a new section 501(c)(25) to the Code to exempt certain corporations and trusts organized to acquire and hold title to real property, to collect the income from the property, and to remit the income therefrom (less expenses) to one or more specified categories of tax-exempt organizations (including qualified pension, profit-sharing, and stock bonus plans) that are the shareholders of the corporation or beneficiaries of the trust.

Since section 501(c)(25) states explicitly that the functions of the title-holding company include the collection of income, the payment of expenses, and the distribution of the remaining income, it is implicit that the organization may hold the cash or cash equivalents that are the necessary incidents of these activities. However, the Joint Committee staff's description of the Bill states that "a section 501(c)(25) title-holding company may only hold real property" and (if the Bill is enacted) certain personal property that is leased under, or in connection with, a lease of real property. See Staff of Joint Comm. on Taxation, Description of the Technical Corrections Bill of 1987, 100th Cong., 1st Sess. 280 (1987).

The Internal Revenue Service has recognized that a section 501(c)(2) title-holding company may retain part of its income each year to apply to indebtedness on property to which it holds title. See Rev. Rul. 77-429, 1977-2 C.B. 189. There is no justification for treating a section 501(c)(25) title-holding company less favorably than a section 501(c)(2) title-holding company in this respect. Accordingly, the Bill should clarify that a section 501(c)(25) title-holding company may retain income to defray its expenses.

9. Buy-Back Rights.

The Bill should clarify that a plan may require the repayment of a withdrawal made on account of an employee's separation from service before the close of the first period of five consecutive one-year breaks in service commencing after the date of the separation from service.

Section 1898(a)(4) of the Act amended Code section 411(a)(7)(C) and ERISA section 204(e) to provide that a plan may require the repayment of a withdrawal made on account of separation from service before the close of the first period of five consecutive one-year breaks in service commencing after the date of the withdrawal. Under Treas. Reg. § 1.411(a)-7(d)(4), a withdrawal is deemed to be made on account of an employee's separation from service if it is made not later than the close of the second plan year following the plan year in which the separation occurs. Accordingly, an employee might have incurred as many as three consecutive one-year breaks in service on the date of his withdrawal.

If the employee is permitted to repay such a withdrawal at any time before the close of five consecutive one-year breaks in service commencing after the date of the withdrawal, the employee will be able to make the repayment (and thus to "buy back" the forfeitable portion of his accrued benefit) at any time before he has incurred a total of eight consecutive one-year breaks in service. This provision is inconsistent with section 411(a)(6)(C) of the Code, which permits a plan to provide that the nonforfeitable percentage of the benefit accrued prior to the employee's separation from service will not increase after he has incurred five consecutive one-year breaks in service. The suggested technical correction would conform the repayment rule in section 411(a)(7)(C) to the vesting rule in section 411(a)(6)(C).

10. Technical Corrections to COBRA.

a. Foreign Plans. The Act amended the definition of "qualified beneficiary" in Code section 162(k)(7)(B)(iii) to exclude any individual whose status as a covered employee is attributable to a period during which the individual was a nonresident alien receiving no earned income from sources within the United States. However, the amendment failed to address the case of a United States citizen who is employed by a foreign affiliate of a United States company and who is covered by a foreign medical plan. Unless a technical correction is adopted to address this situation, the foreign medical plan will be required to provide health care continuation coverage to the United States citizen and his dependents. This result clearly was not intended by Congress and is inconsistent with the provision that appears in ERISA (but not in the Code) which exempts plans maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens. See ERISA § 4(b)(4).

In order to avoid an inconsistency between the health care continuation provisions of the Code and the health care continuation provisions of ERISA, the Bill should amend the Code to create a parallel exemption for foreign plans. Large multinational companies are often not aware of the number and identity of the United States citizens working abroad for their foreign affiliates. This is particularly true where the United States citizen is hired abroad and is not a transferee from a domestic affiliate. There is no suggestion in either the statute or the legislative history that Congress intended to extend COBRA protection to employees who work abroad. Indeed, section 4(b)(4) of ERISA strongly indicates that Congress intended not to provide such protection.

As a practical matter, it is difficult to imagine how multinational companies will be able to teach their plan administrators around the world to understand the COBRA regulations and to send timely COBRA notices to their nonresident United States citizen employees and their dependents. There is absolutely no reason to believe that Congress intended to impose these burdens on foreign plan administrators or to impose draconian penalties on multinational companies in the event of a single default by a foreign plan administrator. Accordingly, the Bill should amend section 162(k)(7)(B)(iii) to eliminate the inconsistency between the Code and ERISA.

b. Controlled Group Rules and COBRA Sanctions. Section 111B(a)(17) and (19) of the Bill would apply COBRA's health care continuation requirements on a controlled group basis. As a result, a single violation of the COBRA requirements by a plan to which one member of a controlled group of corporations contributes causes all of the members of the group to lose all of their deductions for contributions to all of their group health plans. In addition, all highly compensated employees of the controlled group lose the benefit of the exclusion for employer-provided group health benefits unless all of the group health plans maintained by the controlled group satisfy the COBRA requirements.

ERIC believes that the sanctions imposed for noncompliance for COBRA are excessive. When these excessive sanctions are imposed on a controlled group basis, the sanctions become nothing less than an exercise in overkill. A large controlled group of corporations with thousands of employees could lose hundreds of millions of dollars in tax deductions merely because one small affiliate failed, perhaps inadvertently, to comply with COBRA. Moreover, all highly compensated employees in the controlled group in this situation would lose the benefit of the exclusion for employer-provided group health coverage merely because of actions that were totally beyond the control of all but a handful of those employees.

Accordingly, ERIC urges that the COBRA sanctions not be applied on a controlled group basis and that the statute be amended to waive the sanctions where the violations of COBRA are isolated, the result of a good faith effort to comply, or are corrected on a retroactive basis.

11. Technical Corrections to the Tax Reform Act of 1984.

Section 1852(h)(1) of the Tax Reform Act of 1986 made a technical amendment to section 528 of the Tax Reform Act of 1984.

The 1984 Act required that amounts contributed to a section 401(h) arrangement for plan years beginning after March 31, 1984, for retiree health benefits with respect to a five-percent owner must be (i) maintained in a separate account and (ii) treated as "annual additions" for purposes of the limits under Code section 415.

The 1984 Act added a similar requirement to section 419A of the Code for contributions paid or accrued after December 31, 1985, in plan years ending after that date, with respect to key employees.

The technical correction in the 1986 Act sought to eliminate the inconsistency between sections 401(h) and 419A by amending section 401(h) to make it apply to key employees rather than to five-percent owners. However, in eliminating one inconsistency, the Bill created another, since the change was made effective retroactively to plan years beginning after March 31, 1984 (the effective date of the original section 401(h) separate account requirement for five-percent owners) rather than for contributions paid or accrued after December 31, 1985 (the effective date of the section 419A separate account requirement for key employees).

There is no justification for the earlier retroactive effective date. If the objective is to treat key employees in the same manner under section 401(h) as under section 419A, the effective date for section 401(h) arrangements should be identical to the effective date for section 419A plans. Moreover, adopting a retroactive effective date for section 401(h) arrangements creates serious practical problems; the retroactive change in the law could cause an employee to exceed the section 415 limits retroactively, long after the employer had a timely opportunity to correct the problem. An excess annual addition would be particularly difficult to correct if the employee has already separated from service or has died.

We urge that the Bill be amended to change the effective date of section 1852(h)(1) of the 1986 Act to plan years beginning after December 31, 1986. If this is not acceptable, the effective date should at least be changed to be no earlier than the effective date of the separate account rule under section 419A (contributions paid or accrued after December 31, 1985, in plan years ending after that date).

Estate Planning Services

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Evangelical Covenant Church • Covenant Benevolent Institutions • North Park College and Theological Seminary

June 30, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I am deeply concerned about IRC Section 501(m), that portion of the Tax Reform Act of 1986 dealing with charitable gift annuities. I am writing to ask your support amending the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities are not subject to Section 501(m).

Charitable gift annuities are not the same as commercial type insurance annuities. They are issued by IRC 501(c)(3) charitable organizations and do not compete with commercial annuities. Charitable gift annuities have been used for over 100 years, and are a significant source of gift monies to charitable organizations. Most of these gifts would be lost if the new tax law is not clarified and charitable gift annuities remain subject to IRC Section 501(m).

Another point should also be made: charitable remainder annuity trusts have already been exempted from IRC 501(m). Annuity trusts are used primarily by larger donors, while the donors of smaller gifts use the charitable gift annuity. It is unfair for the larger donor's gift to be exempted from this provision of the tax act, while penalizing the smaller donor.

Please support an amendment to the Technical Corrections Act of 1987 clarifying the position on charitable gift annuities--specifically that they be exempted from IRC Section 501(m) under TRA 86.

Sincerely,

LeRoy M. Johnson

LeRoy M. Johnson
Executive Director of
Estate Planning Services

LMJ:pc

78-959 973

September 11,1987

Sirs;

As a single mother and a published romance writer of sixteen books for three publishing houses, I protest against the new 1986 Tax Reform act -- the TRA-86.

I ask that clarification be made in the Technical Corrections Bill S350, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

Unlike article writers who are paid only once for a project -- and paid immediately upon acceptence -- a novelist's payback is already strung out over a series of years (a minimum of one payment to a maximum of ?. Reprints? Discounts? No distribution? Some never received more than their advance, some only their books as an advance.) It takes a year from the time it's finished until the book is in print... and a year can make a drastic change in the audience or the sale of a particular topic. It would be near impossible to judge in advance the amount of money earned on any book -- and any second guessing would never be equal for both author and government. It would <u>always</u> favor government. Indeed, it already does. Along with the already existing hardships facing writers, this new burden could make more creative people fall by the wayside rather than fight the system. It's already easier to receive a paycheck on a regular basis -- like you do -- than to try to budget money that sometimes comes in twice a year and sometimes doesn't....

<u>Please</u> think again. Isn't there some big top ten corporation out there not paying taxes? Couldn't you try going after them for a while instead of always hitting the middle-income man -- or woman?

Sincerely,

Rita Clay Estrada

Rita Clay Estrada
4314 Annawood Circle
Spring, Texas 77388

Mission Fields in Egypt, Ethiopia, Sudan, Bolivia, Guatemala, El Salvador, Honduras, Korea, Alaska and Brazil

Evangelistic Faith Missions

P. O. Box 609, Phone 812-275-7531
Bedford, Indiana 47421

Missionary Herald
$1.00 per year

July 13, 1987

Dear Sir:

Evangelistic Faith Missions is a non-profit religious corporation, duly organized and existing since October 24, 1921, under the laws of the State of Indiana. The corporate purposes and powers of our Mission are: "To conduct evangelistic work, to establish, support, and maintain and conduct home and foreign missions, and to establish, support, maintain and conduct orphanages in foreign countries, and to accept gifts, donations and endowments for the above objects. * * *." Our Mission is also an IRC Sec. 501 (c) (3) organization and sometimes issues gift annuities to donors who support its work.

We are deeply concerned that IRC Sec. 501 (m) -- enacted by TRA 1986 -- might be construed so as to treat gift annuities as "commercial-type insurance." Please amend the Technical Corrections Act of 1987 (H.R. 2636) to provide that gift annuities issued by IRC Sec. 501 (c) (3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

We use gift annuities to accommodate interested donors who desire to make a gift to help our organization. Such gift annuities do not compete with commercial annuities and are not "commercial-type insurance". Gift annuities have been used by charitable and religious organizations for over 100 years. Failure to clarify the law as stated above will probably dry up an important source of funds which are sorely needed to support charitable and religious work.

Your prompt attention and helpful assistance will be deeply appreciated.

Very truly yours,

By: J. B. Juddie Peyton
Reverend J. B. "Juddie" Peyton
President and Director of
Evangelistic Faith Missions

LAW OFFICES OF
EVANS & FROEHLICH

Laura Wilcox
Committee on Finance, Hearing Administrator
United States Senate, Room SD-205
Washington, D.C. 20510

RE: Comments on the Technical Corrections Act of 1987 (HR 2636 and S 1350); Tax-Exempt Bonds and Intergovernmental Cooperation

Dear Ms. Wilcox:

Please accept and appropriately file and present this as my formal written comments in connection with the Technical Corrections Act of 1987 (HR 2636 and S 1350, collectively, the "Bill"). The Bill provides technical corrections to the Tax Reform Act of 1986 (the "Act"), which enacted the Internal Revenue Code of 1986 (the "Code").

TAX-EXEMPT BONDS AND INTERGOVERNMENTAL COOPERATION

These comments will concern selected provisions of the Act and the Code as they affect tax exempt bonds and local intergovernmental cooperation. The essential problem is that the Act and the Code seem to assume that all issuers of tax exempt bonds are a single governmental entity. Although this appears to be an inadvertency, certain tax exempt bond provisions of the Act and the Code frustrate and discourage local intergovernmental cooperation. The selected provisions which these comments will address, concerning adverse intergovernmental cooperation consequences, are as follows:

1. The $5,000,000 so-called "small issuer" exception of Section 148(f)(4)(C) of the Code related to arbitrage rebate.

2. The $10,000,000 "qualified tax-exempt obligation" exception to financial institution non-deductibility of Section 265(b)(3) of the Code.

3. The "available" revenues feature of footnote 173 of the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 (the "Blue Book") concerning Section 148(f)(4)(B)(iii)(II) of the Code.

SECTION 148(f)(4)(C) SMALL ISSUER EXCEPTION

Section 148 of the Code basically provides, with certain exceptions, that to the extent investment yield on bond proceeds exceeds the yield on the bonds the excess is to be rebated to the federal Treasury. Among the ways to avoid the rebate requirement, bond proceeds can be spent in 6 months or the investment of bond proceeds can be in tax-exempts. Up to $100,000 of debt service fund earnings are excepted from rebate. Of the exceptions, the $5,000,000 so-called "small issuer" exception is perhaps the most critical. That exception is expressed in Section 148(f)(4)(C) as follows:

(C) EXCEPTION FOR SMALL GOVERNMENTAL UNITS. -- An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraphs (2) and (3) if--

(i) the issue is issued by a governmental unit with general taxing powers,

(ii) no bond which is part of such issue is a private activity bond,

(iii) 95 percent or more of the net proceeds of such issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer), and

(iv) the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such unit (and all subordinate entities thereof) during the calendar year in which such issue is issued is not reasonably expected to exceed $5,000,000.

The intergovernmental cooperation concern relates to paragraph (i)--"the issue is issued by a governmental unit with general taxing powers." Let's look at an example where two cities and a county form an intergovernmental contractual association (the "Association") to develop a landfill located in the county's unincorporated area for the disposal of solid waste.

The Association is not a governmental unit. It is an intergovernmental contractual association. It does not have taxing power. Let's assume that otherwise it complies with Section 148(f)(4)(C). This will not be an unusual situation, at least under the constitution and laws of the State of Illinois where there is very broad authority to engage in intergovernmental cooperation. Let's also assume that the landfill is an Association owned and operated facility. There is no "private activity" feature involved.

Because of the requirement of Section 148(f)(4)(C)(i) of the Code that the Association be a "governmental unit with general taxing powers" the Association's bonds to finance the landfill or its operations are not literally subject to the $5,000,000 small issuer exception. It is not a governmental unit, and it does not have taxing power. Let's also assume that the Association plans a $675,000 issue to fund its operations for a year and to pay preliminary engineering and hydrogeology costs related to the preliminarily selected landfill site. Let's also assume that the two cities and the county provide part time personnel services to the Association to assist its start up. This Association is literally subject to the arbitrage rebate requirements for its $675,000 "seed money" issue.

To dramatize what this means, Infrastructure News (May 1987, CD Publications, Silver Spring, MD) reported that the Treasurer of the State of Maine said that with respect to a $1,151.59 rebate on a note issue the cost to the State of Maine was $100,000 for the investment, computation, bidding and return requirements concerning arbitrage rebate under Section 148(f) of the Code. Assuming that $100,000 might be an exaggeration, we all know from our experiences with Section 103(c)(6) of the Internal Revenue Code of 1954, as amended, and the related Treasury Regulations §1.103-15AT that many multiples of $1,151.59 would not be surprising in that case. Even proving there is no rebatable amount will likely be expensive. It is critical for a small issuer to be able to use an exception.

The Association's landfill is clearly a governmental function. A landfill is a necessary, if not critical, requirement in any solid waste disposal approach. Recycling, energy conversion and other approaches always leave some residual amount for landfill disposition. The Association is marginally staffed. The amount of $675,000 is hardly a large issue. This is 1 to 2 years of operating funds while site selection proceeds. Under Section 148(f) of the Code the Association should invest, rebate, compute yields and otherwise comply with certain technical tax rituals even to prove it should rebate nothing.

This could be avoided. For example, the two cities and the county could each issue $225,000 and make it available to the Association. This would mean three sets of issuance costs. This is senseless and seemingly an unintended result of the Code. However, as written the Code appears to require it. Section 148(f)(4)(C)(i) needs technical correction, or at least clarification, in order to allow this and similar small issues for clearly governmental purposes to proceed without the threat and cost of arbitrage rebate.

The Association is made up of three local governmental units which each have general taxing powers. The Association is not a Section 501(c)(3) entity. The Association is an intergovernmental contractual association of three local governmental units. The Association issues bonds "on behalf of" those three local governmental units. However, where those three local governmental units under plainly available intergovernmental cooperation authority of the State's constitution and laws jointly created the Association to undertake and exercise a clearly governmental function, Section 148(f)(4)(C)(i) of the Code should be corrected, or sufficiently explained, to allow this sort of "on behalf of" intergovernmental cooperation effort to avail itself of the $5,000,000 small issuer exception to Section 148(f) rebate.

The federal government should not discourage and frustrate local intergovernmental cooperation by an unforeseen and unintended result of the "general taxing powers" provision of paragraph (i) of Section 148(f)(4)(C). This and an appropriate allocation of an intergovernmental issue to the superior entities can be very easily done by a corrective provision or explanatory statement to the effect, as follows: An intergovernmental entity created by governmental units having general taxing powers shall be deemed to comply with Section 148(f)(4)(C)(i) and each such governmental unit shall be allocated its proportionate share of the intergovernmental issue.

There is another problem with the $5,000,000 small issuer exception in Section 148(f)(4)(C). It does not anticipate that the issuing entity could be multijurisdictional, such as in the case of the Association. Where the issuing entity is multijurisdictional, how would the issue amount be allocated to those local governments that created and established the Association? Is it 1/3 to each, or some other fraction (e.g., population ratios) based upon the intergovernmental agreement creating and establishing the Association? Is each to be allocated 100% so the effect is to essentially multiply the impact of the Association's issue? What if 10 or 20 local governments (a real possibility in Cook County, Illinois) intergovernmentally cooperate? Does this mean that the issue's impact is allocated and multiplied 10 or 20 times? Certain authors of the Blue Book and Treasury staff have divided in their public and private reactions to this. Some say it is allocated 100%; some say it is divided; and all say they haven't thought about it before, don't know and aren't sure. Obviously, multiplying the issue by allocating 100% to each superior entity will have a discouraging and frustrating impact on intergovernmental cooperation. It does not seem that this is an intended or required result of the Code. However, staff members are divided and confused in their reactions to this and how it is to be treated. Therefore, technical correction and clarification to require an allocation is appropriate.

Of course, there is a way to avoid this at the local level. Each city and the county could issue its own bonds and make the proceeds available to the Association. This senselessly expensive and time consuming technique of multiplying issuance costs does not seem to be intended by tax reform to be the way to use the $5,000,000 small issuer exception in Section 148(f)(4)(C) in an intergovernmental context. If the exception can be utilized in that way, why not clearly allow the single intergovernmental cooperation issue in the first instance. Tax reform surely did not intend to discourage and frustrate intergovernmental cooperation. Nowhere in the Code is local intergovernmental cooperation recognized in this context. This unanticipated and unintended result is proper for technical correction, or at least clarification in the legislative record. The way Section 148(f)(4)(C)(i) is written it would seem most unlikely that regulations (which will be too late and, in the usual case, likely narrowly written) could or will provide relief.

Section 113(a)(17)(A) of the Bill in the context of intergovernmental cooperation, in much the same manner described above concerning Section 265(b)(3) of the Code, almost mandates a multiplication of the impact of an issue similar to that planned by the Association. This adds more confusion in the context of local intergovernmental cooperation and deserves clarification and appropriate correction.

SECTION 265(b)(3) SMALL ISSUER EXCEPTION

Section 265(b)(1) of the Code basically provides, subject to certain exceptions, that banks, savings and loan associations and other financial institutions may not deduct any of their interest costs of purchasing and carrying obligations acquired after August 7, 1986, the interest on which is excluded from gross income under Section 103 of the Code. Section 265(b)(1) provides that in the case of such financial institutions "no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest" for bonds acquired after August 7, 1986. Prior to the 1986 Code such financial institutions could deduct 80% of such interest expenses.

There is a so-called $10,000,000 "small issuer" exception from the general rule of nondeductibility. It is available only for certain governmental and qualified 501(c)(3) bonds. That small issuer exception applies only to "qualified tax-exempt obligations". Section 265(b)(3) of the Code provides:

(3) EXCEPTION FOR CERTAIN TAX-EXEMPT OBLIGATIONS.--

(A) IN GENERAL.--Any qualified tax-exempt obligation acquired after August 7, 1986, shall be treated for purposes of paragraph (2) and section 291(e)(1)(B) as if it were acquired on August 7, 1986.

(B) QUALIFIED TAX-EXEMPT OBLIGATION.--For purposes of subparagraph (A), the term 'qualified tax-exempt obligation' means a tax-exempt obligation which--

(i) is not a private activity bond (as defined in section 141), and
(ii) is designated by the issuer for purposes of this paragraph,

For purposes of the preceding sentence and subparagraph (C), a qualified 501(c)(3) bond (as defined in section 145) shall not be treated as a private activity bond.

(C) LIMITATION ON ISSUER.--An obligation issued by an issuer during any calendar year shall not be treated as a qualified tax-exempt obligation unless the reasonably anticipated amount of qualified tax-exempt obligations (other than private activity bonds) which will be issued by such issuer during such calendar year does not exceed $10,000,000.

(D) OVERALL $10,000,000 LIMITATION.--Not more than $10,000,000 of obligations issued by an issuer during any calendar year may be designated by such issuer for purposes of this paragraph.

(E) AGGREGATION OF ISSUERS.--For purposes of subparagraphs (C) and (D), an issuer and all subordinate entities thereof shall be treated as 1 issuer.

With respect to the Association's plans for 1987, the $675,000 issue does not present any problems. The Association does not contemplate the issuance of bonds in 1987 such that it could fail to qualify for the $10,000,000 small issuer exception. However, if plans proceed according to schedule, in 1988 the Association reasonably anticipates issuing up to $9 million of bonds to finance the acquisition and construction of a landfill, access roads and related and appurtenant fixtures and equipment. Other financings and increased costs may result in exceeding the $10,000,000 limit for the small issuer exception. In any event, the $10,000,000 limit clearly will resolve one way or the other. As will be shown, the problem likely will be with respect to the two cities and the county.

If the Association exceeds $10,000,000, it clearly cannot utilize the small issuer exception. In this example of an intergovernmental undertaking, the problem is with the aggregation rules in subparagraph (E). That is, how does the $9+ million become allocated to the two cities and the county that constitute the Association? Will they each be attributed $9+ million such that their individual financing plans are compromised as to "bank qualification" by being members of the Association? In computing the $10,000,000, Section 265(b)(3)(E) requires that "an issuer and all subordinate entities thereof shall be treated as 1 issuer". The Association is issuing the bonds "on behalf of" the two cities and the county. The situation, is essentially the same as described above at page--concerning the multiplication of the issue amount under Section 148(f)(C)(4) of the Code. Section 109(b)(5) of the Bill almost reads as though it mandates multiplication of the issue amount for the Association. Instead of clarification another confusing concept is added, particularly as to the impact on intergovernmental cooperation.

There are several approaches to analyze this in the intergovernmental context of the Association. The Association as an issuer has no "subordinate" entity, and, therefore, neither of the cities nor the county are charged with any allocation of the Association's bonds. In fact, the Association is rather the "subordinate" entity of the two cities and the county. We are told by committee and Treasury staff, however, which is the case also above described concerning the $5,000,000 small issuer exception under Section 148(f)(c)(4), the "subordinate" concept actually runs both directions. That is, the superior entity also is charged in computing the exception. Section 109(b)(5) of the Bill would seem to require this as a result in an intergovernmental context. The implications of this analysis for the Association's 1988 plans for a $9+ million issue also affect the $5,000,000 exception under Section 148(f)(4)(C) for the two cities and the county. It is important that the two cities and the county preserve "bank qualification" for their issues by only being allocated a part of the $9+ million Association issue in 1988.

Another approach is to allocate 100% to each of the cities and to the county or to allocate on the basis of 1/3 each (or otherwise as the intergovernmental agreement may allocate costs and benefits--for example, by population ratios). Again, as was the case for the above Section 148(f)(4)(C) analysis, committee and Treasury staff divide among themselves as to the approach. Section 109(b)(5) of the Bill may have created a local intergovernmental problem that did not previously exist. However, as also was the case regarding Section 148(f)(4)(C), the committee and Treasury staff who have commented are unanimous that no one ever considered the local intergovernmental cooperation impacts of the tax exempt bond provisions of the 1986 Code or of the Bill, and particularly as to the allocations of an intergovernmental issue to the contracting local governmental units.

As noted above related to the similar Section 148(f)(4)(C) problem, it is difficult to believe concerning a matter no one even considered that Congress intended to frustrate and discourage local intergovernmental cooperation and activities. This is particularly so concerning clearly governmental activities. The Association's landfill is anticipated to be governmentally owned and operated. There are to be no private activity features.

Since never addressed or considered, the above deserve technical correction and clarification to permit the use of the exceptions with the least impact on the intergovernmentally cooperating units of local government.

INTERGOVERNMENTAL SOPHISTICATION

Staff members of tax writing committee when presented with the above problems and concerns have replied that a major consideration in the small issuer exceptions was to allow concessions to less sophisticated issuers. This is more so with respect to the terrible complexities of arbitrage rebate than financial institution deductibility. Staff reply continues to the effect that the Association as an intergovernmental entity must have a sophistication that justifies unavailability of the exceptions. That is, the economies of scale and size of the Association contradict the use of a rule intended to be available to less sophisticated issuers. They say this is more so under Section 148(f)(4)(C) than Section 265(b)(3).

However, this illustrates a misunderstanding of local intergovernmental cooperation and how entities such as the Association are created, established and at least initially operate. The activities of the Association are not a going concern. Presently the Association has no facilities or staff. This is a new intergovernmental undertaking. The public works, engineering, planning and legal staffs of the two cities and the county, which constitute the Association, are taking this on as an additional duty and function. Much of the professional work is part time and on weekends and evenings. Already these professionals have a full week. In summary, at least for now, the Association is likely less capable or sophisticated than any one of the entities that make it up. This is not unusual for the start up of an intergovernmental undertaking.

Illinois has over 6,500 units of local government. There are approximately 102 counties, 1150 municipalities, 1500 townships, 2000 school districts and over 2000 other special purpose districts, authorities, boards and commissions. Intergovernmental cooperation, activities and undertakings are relatively common. Joint undertakings, such as illustrated by the Association, are encouraged by a great number of provisions in Illinois law. Of particular note are two general provisions: Section 10 (Intergovernmental Cooperation) of Article VII of the Constitution of Illinois and Section 741 et seq. of Chapter 127 of the Illinois Revised Statutes (Intergovernmental Cooperation Act).

The Association is one of a number of joint intergovernmental contractual associations. Such associations of governmental units should be treated as qualifying under Section 148(f)(4)(C)(i) as long as all member entities have general taxing power. The divided allocation (not 100% attribution to each governmental member of the Association) under Sections 147(f)(4)(C) and 265(b)(3)(E) should apply. These points deserve technical correction and clarification. [Although Illinois is described above, as chairman of the National Institute of Municipal Law Officers' Committee on Intergovernmental Cooperation, I suggest to you that this is not unique to Illinois and is of national concern.]

Blue Book-Footnote 173

Returning to arbitrage rebate, Section 148(f)(4)(B)(iii)(II) of the Code concerns tax and revenue anticipation notes and bonds (TRANS). The concern with TRANS is that an issuer will issue bonds for operating revenues when there is no real need for the funds (that is, no "cash flow deficit" exists or is reasonably imminent) and derive an arbitrage profit. This process could be repeated in each fiscal period. Section 148(f)(4)(B)(iii)(II) addresses this by providing that "the term cumulative cash flow deficit means, as of the date of computation, the excess of the expenses paid during the [applicable] period...which would ordinarily be paid out of or financed by anticipated tax or other revenues over the aggregate amount available (other than from the proceeds of the issue) during such period for the payment of such expenses." A major problem is describing what amounts are "available". Footnote 173 of the Blue Book addresses this problem in a far reaching way:

"173/ Congress intended that, for purposes of the rebate requirement, the Treasury Department will adopt rules that provide that deficits are treated as occurring only if no amounts other than bond proceeds are available to the governmental units to pay the expenses for which bond proceeds are to be used. In determining whether an amount is available to a governmental unit, these rules may provide that the fact that the amount is deposited in special purpose accounts or otherwise earmarked is to be disregarded if the governmental unit using the TRAN proceeds either (i) established the restrictions on the use of the other funds, or (ii) has the power to alter the use of the other fund. But see, Treas. reg. sec. 1.103-14(c)(3)."

IRS Notice 87-42 essentially forestalls the application of the more far reaching implications of footnote 173 until its impact and broad definitional reach can be reassessed. However, it is not unreasonable to consider that the definitional problem of "available" could or might be addressed in the debate surrounding the technical corrections Bill.

There are local intergovernmental cooperation implications. The Association again provides an example. It is set up solely as a revenue supported entity on an enterprise fund basis. That is, it is self-supporting based upon its fees and charges, much as many water and sewer systems. The $675,000 issue the Association plans is largely for operating until a revenue generating facility is on line. Thus the planned issue essentially constitutes a TRAN under the 1986 Code.

In the context of the Association, let's assume that as to the two cities, City A has substantial contingency funds and City B has none and that the county is operationally running with expenses exceeding revenues. Within the meaning of footnote 173's treatment of "available", several concerns arise. One, the Association conceivably could borrow from City A. Two, City A participated in the intergovernmental agreement establishing the Association and arguably established the restrictions contained in that agreement related to funding. Three, the two cities and the county have the power to alter the intergovernmental agreement related to funding. In this context, what funds, if any, are "available" within an approach similar to footnote 173? Are there "no amounts other than bond proceeds... available"? Footnote 173 is extraordinarily broad in its literal reach.

As to intergovernmental cooperation in the context described above technical correction and clarification are necessary. Such technical correction and clarification should be to the effect that "available" in Section 148(f)(4)(B)(iii)(II) [and any treatment similar to or succeeding footnote 173] means that all participants must have funds so "available". If any one which has an ownership interest [mere purchase of services by intergovernmental agreement should not qualify] on the same basis as the others [to include a financially weak participant other than on an ownership basis the same as the others would be an abuse as well as an artifice and/or device] does not have funds so "available", a TRAN shall be tested for qualification as to cumulative cash flow deficit on the basis of the least capable. Any other rule would discourage and frustrate local intergovernmental cooperation efforts and activities.

CONCLUSION

Based upon the comments and reactions of House Committee on Ways and Means, Senate Committee on Finance and Treasury staff, no thought was given to the local intergovernmental impacts of the 1986 Code's tax exempt bond provisions. Opportunities for local intergovernmental cooperation are many and are encouraged by the constitutions and laws of most states. Identified above are three selected areas of major concern: (1) Section 148 (f)(4)(C) arbitrage rebate small issuer exception; (2) Section 265(b)(3) small issuer exception covering financial institution deductibility (so-called "bank qualification"); and (3) Section 148(f)(4)(B)(iii)(II) [Blue Book footnote 173] concerning "available" funds and TRANS.

An example involving solid waste disposal and the Association established by two cities and a county was used to illustrate the problems and concerns for which technical correction and clarification efforts are requested. The example in all material respects is not hypothetical. It is provided because it is real and present. The City of Champaign, Illinois, the City of Urbana, Illinois, and the County of Champaign, Illinois, have created and established the Intergovernmental Solid Waste Disposal Association as an intergovernmental contractual association. It is not a unit of local government, and it does not have taxing power. The above substantially describes a planned financing and the impact of tax reform on the Association, the two cities and the county. We are aware of other Illinois projects which may be similar.

Immediate guidance is required in this area that Congress never considered. The regulation process will be too late, and it is difficult to envision other than an unyielding regulation or private ruling approach in an area that Congress has not addressed in the legislative process.

Please don't hesitate to contact me if you need anything further or have any comments or questions. Your collect calls to me, if any, will be accepted, and I would be happy to meet further with you concerning these matters. Six copies of these comments are herewith concurrently delivered.

Very truly yours,

Kurt Froehlich

KURT P. FROEHLICH

VIA FEDERAL EXPRESS

cc: Mary McAuliffe
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ESOP ASSOCIATION WRITTEN COMMENTS ON
S. 1350, TECHNICAL CORRECTIONS ACT OF 1987

Mr. Chairman and members of the Subcommittee on Taxation and Debt Management, the ESOP Association is generally pleased with those provisions of S. 1350 which make techical and clarifying changes to provisions of the Tax Reform Act of 1986 (TRA 86) that affect the establishment and administration of Employee Stock Ownership Plans (ESOPs).

Since passage of TRA 86, the ESOP Association has submitted comments on the ESOP provisions to the tax professionals of the Treasury Department, the IRS, the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation. Many of these comments have been addressed in IRS announcements and guidelines on TRA 86, the "Blue" Book and in S. 1350. Several have not yet been addressed, and several new matters have since been called to our attention.

As usual, your professional and clerical staff have received our comments in a most professional manner.

Anytime a massive piece of legislation like TRA 86 becomes law, very technical questions, and even disagreements, arise over the meaning of the language of the law. And it is understood by all that, despite good faith efforts by Congress, its staff, the Executive Branch and its professionals, the Judiciary and private commentators, some questions and some disagreements over language and meaning will never be resolved.

In this spirit, the ESOP Association has commented on approximately 40 different provisions of TRA 86 since its enactment.

The ESOP Association now submits comments on S. 1350. Some are new comments arising from provisions of S. 1350, and some are repetitions of comments provided earlier, where an amendment or clarification is still needed, or modified where the subject matter is addressed by S. 1350.

Because of the Committee's rules on printing, all substantial comments now follow as an attachment to this written statement. The ESOP Association understands that the attachment will not be reprinted, but will be available for review in the Committee's files.

We appreciate the opportunity to comment on ESOP-related provisions of S. 1350.

ESOP comment 1

Section 111A(c)(2) of S. 1350, relating to section 1123 of TRA 86; Code section 72(t)(2).

Background: This paragraph of S. 1350 completely rewrites the original provisions of TRA 86 that provide for an exemption from the 10% early withdrawal tax for certain distributions from an ESOP. The ESOP Association opposes the S. 1350 rewritten version because: (1) it adds a new substantive requirement in order for an ESOP distribution to be exempted from the 10% early withdrawal tax; (2) the new substantive requirement has no basis in the legislative history pertaining to TRA 86 Section 1123; and (3) the justifiable confusion over the exact meaning of Code section 72(t)(2)(C) may be significantly cleared up with a minor amendment, plus guidance from the Blue Book, IRS Announcement 87-13, and subsequent IRS regulations and guidelines.

Problem: Section 111A(c)(2)provides that in order for an ESOP distribution to be exempt from the 10% early withdrawal tax, 2 tests must be met. The second test is a requirement not in current law that the distributed employer securities must have met at all times in the 5 years prior to distribution the requirements of Code section 401(a)(28) (the ESOP diversification rule) and Code section 409 -- which currently contains rules for both leveraged and tax-credit ESOPs, as well as to a lesser extent stock bonus plans. (We assume that the employer securities in existence prior to January 1, 1987, need not comply with ESOP rules effective post-TRA 86 enactment. For example, section 401(a)(28) does not apply to employer securities acquired in 1984. If those securities were distributed in 1988, the recipient should qualify for the ESOP exemption, if all other requirements were met. If the ESOP Association assumption is wrong, then §111A(c)(2) is a partial repeal of the effective dates of the new ESOP rules included in TRA 86.) This new requirement is harsh because it eliminates the exemption for employer securities distributed from a leveraged and non-leveraged ESOP because their employer securities were not held under the rules of section 409 of the IRC of 1954 (because section 409 of the 1954 IRC primarily contained rules applicable to tax credit ESOPs). For example, under section 409, tax-credit ESOPs are required to vest immediately, to comply with the 84-month rule, and to make allocations based on no more than $100,000 in compensation. Other ESOPs have never been required to comply with these rules.

Furthermore, section 111A(c)(2) does not allow a distribution from an ESOP to qualify for the exception if the employer securities were transferred, or "converted" from a prior qualified plan to the distributing ESOP, because the "converted" plan could not, or would not, meet the requirements of sections 401(a)(28) and 409.

The Conference Report clearly intends that employer securities from converted plans qualify for the ESOP exception:

> "In a case in which a plan is converted to an ESOP, plan assets must have been so invested for 5 plan years prior to distribution...Tacking of investment periods is permitted." (pp. II-457-458 of Conference Report).

The Blue Book also sets forth an intent that tacking from one plan to another is permitted if assets transferred were invested in employer securities in the predecessor plan. (p.718).

But the new requirement of complying "at all times" (i.e., for the 5 years preceding the distribution) with the rules of sections 401(a)(28) and 409 designed strictly for ESOPs, and mainly tax-credit ESOPs prior to 1987, makes transfers ineligible for the ESOP exception.

Finally, the criticism of current law 72(t)(2)(C) has always focused on the words "at all times", which is an absolute term. In the real world, very few things occur "at all times" and this is particularly true of an ESOP. Frequently the ESOP receives cash from the plan sponsor which it uses to buy employer securities. Unless the purchase is instantaneous (which it seldom is), the plan would not comply with a strict "at all times" interpretation. Similarly, an ESOP trustee may invest a portion of plan assets in cash equivalents in order to assure sufficient plan liquidity to meet repurchase liability. Both actions may be prudent trustee actions. Also, a corporate restructuring may result in an existing ESOP holding securities of the new spin-off corporation.

Current law ameliorates the "at all times" language by also setting forth in the general rule for the exception that "on the average, a majority of assets in the plan have been invested in employer securities". Although the "on the average" and "at all times" language do not directly discuss the same rule in current law, the use of "on the average" indicates an intent to reflect in the statute a realistic understanding of ESOP assets.

Section 111A(c)(2), however, drops the reasonable language and proceeds to use "at all times" twice. If enacted as drafted, it would seem to repudiate IRS Announcement 87-13, Q&A 21, which tries to interpret the "at all times" requirement in a more reasonable manner recognizing that it is impossible to meet a literally interpreted "at all times" test.

Solution: Amend only current law clause (ii) of §72(t)(2)(C) to give the IRS regulatory authority to apply the "at all times" test reasonably. Do not adopt the S. 1350 version of 72(t)(2)(C).

Suggestion: Amend Subsection 1123(a) of TRA 86 (Code section 72(t)(2)(C)) to read as follows (added words underlined and deleted words stricken through):

(C) Certain plans -

(i) In General. - Except as provided in clause (ii), any distribution made before January 1, 1990, to an employee from an employer stock ownership plan defined in section 4975(e)(7) or section 409(a) to the extent that, on average, a majority of assets in the plan have been invested in employer securities (as defined in section 409(1) for the 5-plan-year period preceding the plan year in which the distribution is made.

(ii) Benefits Distributed Must Be Invested in Employer Securities For 5 Years. - Clause (i) shall not apply to any distribution which is attributable to assets which have not been invested in employer securities during the period referred to in clause (i) except as provided in regulations prescribed by the Secretary."

In addition, the Committee Report should provide guidance with several examples, including language indicating that (1) a de minimus amount may be held in cash; (2) cash contributions including cash dividends (interim cash) need not be invested in employer securities for a reasonable period of time; and (3) certain corporate reorganizations may result in the replacement of employer securities for a reasonable period of time, taking into account all the facts and circumstances of the reorganization.

Justification: Although the ESOP exception to the early withdrawal tax is to expire January 1, 1990, it is an important ESOP provision because of the early distribution requirement imposed on ESOPs and the concept behind employee ownership that capital ownership produces a supplemental income for a wage earner. Thus, the ESOP Association wants the provision to operate smoothly and effectively as intended by Congress. The recommended changes are in line with the Conference Report (i.e., conversion/transfers qualify and plans in existence less than 5 years qualify), the IRS Announcement 87-13 (tax-credit ESOPs qualify), and the Blue Book (tacking allowed), except for the specific grant of regulatory power to the Secretary. The Committee Report could set forth the intent that the "at all times" language be applied in a reasonable manner, that "tacking" is permitted, and that for plans in existence less than 5 years, the period of existence of the plan is treated as the 5-year plan period.

ESOP Comment 2:

Section 111A(f)(2) and (3) of S. 1350, amending section 1132 of TRA 86; Code section 4980(c)(3).

Background: TRA 86 exempts certain excess reversions from a terminated defined benefit plan from the new excess reversion excise tax if they are transferred to an ESOP.

Problem: Current law requires that the employer securities acquired with the excess reversions stay in the ESOP until distributed in accordance with the plan. This requirement may block a prudent action by the plan trustee (e.g., in the case of a sale of stock). Also, it would help to clarify that a plan sponsor can contribute to another ESOP in order to amortize an ESOP loan, provided that allocations under the combined plans do not breach the 415 limits. Finally, paragraph (3) of section 111A(f) uses the word "amount", which may create confusion if the value of the employer securities appreciate or decline.

Solution: Provide that the Secretary may waive the requirement that securities remain in the ESOP until distribution in accordance with plan, and clarify that the employer may contribute to another ESOP as long as the 415 rules are not breached. Finally, change the word "amount" so that the one-eighth minimum allocation is measured by numbers of shares.

Suggestions: (1) Amend current law section 4980(c)(3)(A)(ii) and (II) to read as follows (new words underlined):

> "(ii) Under the plan, employer securities to which subparagraph (B) applies must remain in the plan until distribution to participants in accordance with the provisions of such plan. The Secretary may waive the requirement of this clause."

(2) Amend subparagraph (B) of section 111A(f)(3) of S. 1350 to read as follows (new words underlined and deleted words stricken through):

> "(B) by adding at the end thereof the following new sentence:
>
> 'The amount allocated in the year of transfer shall not be less than the lesser of the maximum ~~amount~~ number of employer securities allowed under section 415 or 1/8 of the total ~~amount~~ number of employer securities transferred.'"

(3) Clarify in the Committee Report on S. 1350 that the operable limitation on ESOP contributions utilizing section 4980 is section 415. This clarification could be provided by using the Blue Book explanation:

"The amounts held in the suspense account that can be required to be allocated each year are to be allocated to participants' account before any other employer contributions are allocated. In other words, during the period that reversion amounts are held in a suspense account, the employer is not permitted to make additional contributions to the ESOP or any other plan to the extent that the contributions, when added to the amounts held in the suspense account which are required to be allocated each year, would exceed the overall limits on annual additions under a defined contribution plan if allocated to participants' accounts." (p. 753).

Justification: If the release of stock is within applicable 415 limits, there is no reason to prevent the release of stock in a leveraged ESOP in order to amortize an ESOP loan provided required amounts are first released and allocated from the Section 4980 reversion. It is too rigid to "lock-up" the employer stock from any other ESOP transaction that might benefit plan participants.

Using the word "amount", which connotes dollar value, may mean that carefully structured 1/8 releases combined with the sponsor's other plan contributions are unravelled as the employer securities appreciate to the detriment of other plan contributions, or decline to the detriment of the sponsor's ability to contribute. Also, section 4980(c)(3)(C)(ii)(I) indicates that the value for section 415 purposes is established at the time securities are first credited to the suspense account.

ESOP Comment 3:

Section 111A(j)(1) of S. 1350 amending Section 1136 of TRA 86; Code section 401(a)(27).

Background: TRA 86 provides that a determination as to whether a plan is a profit-sharing plan is to be made without regard to the employer's profits. Section 111A(j)(1) requires that in order to qualify under code subsection 401(a), a plan sponsor must designate to the Secretary whether the plan is a money purchase pension plan or a profit sharing plan.

Problem: Because an ESOP is neither a profit-sharing plan nor money purchase pension plan, it would not be qualified under the proposed amendments. (The same could be said of a defined benefit plan, or a stock bonus plan.)

Solution: Either delete the provision of S. 1350; or amend it to include other plans; or amend it by striking the word "subsection" and substitute in lieu thereof "paragraph".

ESOP Comment 4:

Section 111B(h) amending Section 1173 and 1854(c) of TRA 86; Code section 133.

Background: TRA 86 clarified that a qualified 133 loan may not originate with any member of a controlled group, and clarified that a qualified securities acquisition loan may be refinanced and qualify for 133 treatment. S. 1350 provides further clarification as to how long 133 treatment applies to a refinanced loan.

Problem: It is unclear whether a securities transaction loan that is not eligible for 133 treatment (e.g. because it is within a controlled group, or originates with the employer) is eligible for section 133 treatment if refinanced in a manner qualifying for section 133 treatment. Furthermore, it is not clear as to the meaning, or impact, of current law section 133(b)(3)(B) pertaining to "more rapid repayment...of interest", because interest is paid; interest is never "repaid". In addition, the present wording may have the unintended effect of implying that interest payment is a repayment term for determining whether the terms of a lender-to-employer loan and an employer-to ESOP loan are "substantially similar".

Solution: Clarify that an otherwise in eligible securities acquisition loan is eligible for section 133 treatment if refinanced, and delete any reference to repaying interest.

Suggestion: Amend subparagraphs (C) and (D) of 1854(c) of TRA 86 (Code section 133(b)(2) and (3)(B)) would read as follows (added words underlined and deleted words stricken through):

"(2)...
For purposes of this paragraph, subparagraphs (A) and (B) shall not apply to any loan which, but for such subparagraphs, would be a securities acquisition loan if such loan was not originated by the employer of any employees who are covered by the plan or by any member of the controlled group of corporations which include such employer, except that this section shall not apply to any interest received on such loan during such time as such loan is held by such employer (or any member of such controlled group). This paragraph does not apply to a loan used to refinance a loan described in this paragraph unless such a loan is described in subparagraph (A) or (B).

(B) repayment terms providing for more rapid repayment of principal ~~or interest~~ on such loan but only if - "

Justification: The loan origination was not intended to preclude a refinancing which qualifies for the interest exclusion because such a loan benefits plan sponsor and participants with lower debt payments (provided the original loan is used to acquire employer securities after the effective date of section 133).

Note: As presently worded, Code section 133(b)(3), which limits the 133 treatment to 7 years if the qualified loan is refinanced, may not apply to the refinancing of a loan directly to an ESOP as opposed to a loan to the corporate sponsor of the ESOP. S. 1350 clearly limits section 133 treatment to 7 years for refinanced, or a series of refinanced loans, whether the original loan was to the corporation or the ESOP. This problem came to the Association's attention subsequent to our formal review of TRA 86 and S. 1350.

ESOP Comment 5:

Section 111B(g)(3)(B), amending Section 1172 of TRA 86; Code section 404(k).

Background: Section 1118(g)(3)(B) clarifies that a deduction is permitted for dividends paid on allocated ESOP stock used to pay ESOP debt if employer securities in equal to the dividends are released to participant accounts. Because the payment of dividends on ESOP stock, and their distribution to plan participants creates a variety of anomalies with requirements pertaining to distribution under 401, 409, and 4975, Congress added language to Code section 404(k) clarifying any distribution under 404(k) does not violate any 401, 409, and 4975(e)(7) requirements.

Problems: (1) The word "amount" may cause confusion if the value of employer securities appreciates or declines in relationship to the value of dividends used to pay debt.

(2) Paragraph (e)(7) of code section 4975 defines an employee stock ownership plan. By limiting the reference to paragraph (e)(7), the current 404(k) provision leaves open to interpretation whether a dividend distribution to ESOP participants or the use of the dividends to pay an ESOP loan might not comply with Code section 4975(d)(3), the ESOP exemption from the prohibited transaction rules. Also, by addressing only the distribution of dividends, section 404(k) fails to clarify that dividends used to pay ESOP debt (the dividends are thus not distributed) do not cause an ESOP to violate sections 401,409, 4975(d)(3) and (e)(7).

Solutions: (1) Delete the word "amount".

(2) Clarify that Code section 404(k) dividends do not violate the prohibited transaction provisions.

Suggestions: (1) The sentence at the end of Code section 404(k)(2)(C) would read as follows (deleted word stricken through):

"Paragraph (2)(C) shall not apply to dividends from employer securities which are allocated to any participant unless the plan provides that employer securities ~~in an amount~~ equal to such dividends are allocated to such participant for the year which (but for paragraph (2)(C)) such dividends would have been allocated to such participant."

(2) Add "and (d)(3)" to paragraph 1854(b)(3) and the words "or used to make payments on a loan described in section 404(a)(9)". The flush portion of code section 404(k) would then read as follows (added reference and words underlined):

"(k)...
Any deduction under subparagraph (A) or (B) of paragraph (2) shall be allowed in the taxable year of the corporation in which the dividend is paid or distributed to the participant under paragraph (2) <u>or used to make payments on a loan described in section 404(a)(9)</u>. A plan to which this subsection applies shall not be treated as violating the

requirements of section 401, 409, or 4975(d)(3) and (e)(7) merely by reason of any distribution described in paragraph (2). The Secretary may disallow the deduction under this subsection for any dividend if the Secretary determines that such dividend constitutes, in substance, an avoidance of taxation. Any deduction under paragraph (2)(C) shall be allowable in the taxable year of the corporation in which the dividend is used to repay the loan described in such paragraph."

Justification: (1) Clarifies that employer securities equal to value of dividends paid on debt are to be allocated to participants.

(2) Code section 4975 sets forth prohibited transactions and the tax thereon. Paragraph (e)(7) only defines what is an ESOP. The intent was to reference all the ESOP rules, not just 4975(e)(7). To eliminate any doubt whether an ESOP deductible dividend distributed to participants or used to pay an ESOP loan is a prohibited transaction, the reference also needs to include Code section 4975(d)(3).

NOTE: Proposed section 404(k)(2)(C) provides that in order to deduct dividends on allocated employer securities, when the dividends are used to pay an ESOP loan, a minimum allocation of employer securities must be made to plan participants. It is not clear whether this minimum allocation requirement may be satisfied with securities released from the suspense account (and allocated to participant accounts under section 54.4975-11 of the Income Tax Regulations) by reason of the use of dividends on allocated shares to repay the ESOP loan. Although this problem came to the ESOP Association's attention subsequent to the Advisory Committee's technical critique of TRA 86, the Association believes a clarification on this point would be helpful.

ESOP Comment 6:

Section 111B(i)(1), amending TRA 86 section 1174; Code section 409(d)(1)

Background: Section 111B(i)(1) cross references to 401(k)(10)(B)(ii) (which is added by S. 1350 to clarify the rules for distributions upon the termination of a plan or the disposition of assets, because the tax-credit for ESOP contribution was repealed and the 84-month rule is to be, in essence, waived.

Problem: The waiver of the 84-month rule references the requirement that a terminated plan must distribute in a lump sum as defined by section 402(e)(4) (as referenced by 401(k)(10((B)). This creates unintended results. For example, if an employer also maintains a stock bonus plan, employees' distributions from a terminated tax-credit ESOP would not qualify for lump-sum distribution treatment unless employees' stock bonus account balances are also distributed in the taxable year. Also, the REA pre-retirement consent requirement precludes a forced distribution, raising the possibility that an employee could not terminate a TRASOP/PASYSOP if a single employee objects to the distribution. This was not the intent of the amendment.

Solution: Add to paragraph 409(d)(1) a new exception to the 84-month rule that the rule does not apply in the event of the total discontinuance of plan contributions.

Suggestion: Add to paragraph 1174(a)(1) of TRA 86, the words "or complete discontinuace of contributions". Code section 409(d)(1) would read as follows (added words underlined and deleted words stricken through):

"(1) death, disability, separation from service, ~~or~~ termination of the plan~~;~~ , or complete discontinuance of contributions."

Justification: This addition would allow the employer to distribute account balances in a simple manner from a terminated or a dormant plan without having to make the employees wait up to 7 years. Congress has repealed TRASOP/PAYSOPs, and there is no reason to complicate their phase-out.

ESOP Comment 7

Section 111B(j) of S. 1350, amending section 1175 of TRA 86; Code section 401(a)(28).

Background: The House wanted to make ESOP assets more diversified as participants approach retirement age. This desire led the House to impose a requirement on ESOPs that allows a participant to diversify his or her account away from one asset, the employer's stock, as retirement age approaches. Because this new rule is a major change in how ESOPs operate, the House decided to apply the rule prospectively -- to stock acquired by the ESOP after December 31, 1986.

Problem: The contribution to an ESOP or PAYSOP usually occurs several months after the close of a plan year or tax year. For example, assume a PAYSOP sponsor has a calendar plan and tax year ending December 31, 1986. This PAYSOP sponsor will make its last tax-credit eligible contribution sometime in 1987. As written, Code section 401(a)(28) requires that this last PAYSOP contribution (and only this last one) be eligible for diversification. This diversification requirement for a relatively small amount of stock would create a needless administrative problem.

Solution: Exempt PAYSOPs from 401(a)(28).

Suggestion: Delete from paragraph 401(a)(28)(A) the words "or a plan which meets the requirements of section 409(a)." Code section 401(a)(28)(A) would then read as follows (deleted words stricken through):

"(A) In General. - In the case of a trust which is part of an employee stock ownership plan (within the meaning of section 4975(e)(7)) ~~or a plan which meets the requirements of section 409(a),~~ such trust shall not constitute a qualified trust under this section unless such plan meets the requirements of subparagraphs (B) and (C)."

Justification: Diversifying the last contribution to a PAYSOP will not serve Congressional intent in enacting the ESOP diversification rule because -

o there is no evidence that any sponsor of a PAYSOP ever had the PAYSOP as the only ERISA plan for employees;

o typically, employees' account balances are relatively small in relation to other benefits provided by the employer.

o generally, only a small percentage of the sponsor's shares outstanding are held by a PAYSOP; and

o the amount of value of the last year contribution is more than likely less than the cost per account if diversification is required.

ESOP Comment 8

Section 111B(j) of S. 1350, amending section 1175 of TRA 86, TRA 86 subsection 1175(a)(1); Code section 401(a)(28)(B).

Background: See Comment 7

Problem: As written, the ESOP diversification rule may require the diversification of ESOP assets invested in other than employer securities. (ESOPs are required to include a statement that they are designed to invest "primarily" in employer securities.) Very few ESOPs have assets consisting only of employer securities. The non-employer security assets of an ESOP may be cash equivalents, or any other of a variety of investments.

Solution: Clarify that the ESOP diversification rule applies only to the portion of a participant's account invested in employer securities acquired after 1986.

Suggestions: Add to clause 401(a)(28)(B)(i) the words "invested in employer securities", which clause would then read (added words underlined):

"(i) In General. - A plan meets the requirements of this subparagraph if each qualified participant in the plan may elect within 90 days after the close of each plan year in the qualified election period to direct the plan as to the investment of at least 25 percent of the participant's account in the plan invested in employer securities (to the extent such portion exceeds the amount to which a prior election under this subparagraph applies).

In the case of the election year in which the participant can make his last election, the preceding sentence shall be applied by substituting '50 percent' for '25 percent'."

Justification: The purpose of the ESOP diversification rule is to permit a participant to partially "get out" of employer stock. The rule should not require diversification of that which is already diversified. Because an ESOP must be designed to be primarily invested in employer stock, not diversifying the non-employer stock assets will not in any way weaken the purpose of the ESOP diversification rule. The Blue Book (on page 838) sanctions the plan sponsor using "alternative assets" in the plan to satisfy a diversification instruction. The clear thrust of the Blue Book position (and the legislative intent) is that the non-stock assets are not subject to diversification.

ESOP Comment 9

Section 111B(j) of S. 1350, amending Section 1175 of TRA 86; Code sections 401(a)(28)(B) and 402(e)(4).

Background: The House recognized that mandating an employer to maintain three investment options under the diversification rule might create a burden on some ESOP sponsors. Thus it authorized a distribution of the amount the participant elects to diversify.

Problem: If the participant receives a distribution pursuant to an ESOP diversification election after age 59-1/2, current law may deem that distribution to be the only lump sum distribution under the special tax rules for lump sum distributions.

Solution: Exclude a distribution pursuant to an ESOP diversification election from the definition of "lump sum distribution".

Suggestion: Add words "and does not include amounts distributed because of a distribution under 401(a)(28)(B)" to paragraph 402(e)(4). Code section 402(e)(4) would then read as follows, (added words underlined):

"(A) Lump sum distribution. - For purposes of this section and section 403, the term 'lump sum distribution' means the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient -

(i) on account of the employee's death,
(ii) after the employee attains age 59-1/2,
(iii) on account of the employee's separation from the service, or
(iv) after the employee has become disabled (within the meaning of section 72(m)(7)).

from a trust which forms a part of a plan described in section 401(a) and which is excempt from tax under section 501 or from a plan described in section 402(a). Clause (iii) of this subparagraph shall be applied only with respect to an individual who is an employee without regard to section 401(c)(1), and clause (iv) shall be applied only with respect to an employee within the meaning of section 401(c)(1). Except for purposes of subsection (a)(2) and section 402(a)(2), a distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution. For purposes of this subparagraph, a distribution to two or more trusts shall be treated as a distribution to one recipient. For purposes of this subsection, subsection (a)(2) of this section, and subsection (a)(2) of section 403, the balance to the credit of the employee does not include the accumulated deductible employee contributions under the plan (within the meaning of section 72(o)(5))~~.~~ , and does not include amounts distributed because of a distribution under section 401(a)(28)(B)."

Justification: Because a 401(a)(28)(B) distribution does not authorize a full distribution of the account, there is no reason to treat the distribution as a lump sum distribution. The diversification requirement was not intended to disqualify employees' subsequent distributions for lump sum distribution treatment. Disallowing this exception would disadvantage employees.

ESOP Comment 10

Section 111B(j) of S. 1350, amending section 1175 of TRA 86; Code sections 401(a)(28)(B) and 402(a)(5)(D)(i).

Background: Because the House decided to allow the ESOP diversification election to be met by a distribution, the House also decided that such a distribution would be eligible for a tax-free rollover to an eligible retirement plan. It is also necessary to note that TRA '86 subparagraph 1175(a)(2) made the diversification rule apply only to stock acquired after December 31, 1986.

Problem: Many ESOP sponsors, in order to ease administrative burdens, will want to allow a participant to diversify both pre-1987 and post-1987 employer stock. In other words, they will want to go beyond the minimum legal requirements. Because clause (i) of 402(a)(5)(D) seems to allow a tax-free rollover only of the amounts required to be diversified, a more generous diversification amount may not be eligible for a tax-free rollover.

Solution: Substitute the word "permitted" for the word "described" in Code section 402(a)(5)(D)(i), which would then read as follows (added word underlined, deleted word stricken through).

"(i) Requirements. - Subparagraph (a) shall apply to a partial distribution only if the employee elects to have subparagraph (A) apply to such distribution and such distribution would be a lump sum distribution if subsection (e)(4)(A) were applied -

(I) by substituting '50 percent of the balance to the credit of an employee' for 'the balance to the credit of an employee',
(II) without regard to clause (ii) thereof, the second sentence thereof, and subparagraph (B) of subsection (e)(4).

Any distribution ~~described~~ permitted in section 401(a)(28)(B)(ii) shall be treated as meeting the requirements of this clause.

Justification: The Congressional purpose of encouraging ESOP participants to diversify their accounts is enhanced by greater diversification than is required by the diversification rule. This enhancement should not be thwarted by doubt as to whether amounts greater than the required amounts are eligible for a tax-free rollover. The Blue Book on page 836 states that a more generous diversification percentage than that required by section 401(a)(28)(B) is permissible.

ESOP Comment 11

Section 111B(k) of S.1350, amending section 1176 of TRA 86; Code section 401(a)(22).

Background: Section 1176 of TRA 86 was a Senate floor amendment narrowly drawn to limit voting rights pass-through on ESOP stock of certain newspapers.

Comment: Section 111B(k), by amending the voting rights provision in Section 401(a)(22), may make a substantive change in the law pertaining to stock bonus plans of publicly traded corporations. There is no evidence to indicate Congress wanted to change the voting rights of stock bonus plans sponsored by publicly traded corporations.

ESOP Comment 12

Subsection 1174(b) of TRA 86 pertains to the period of time an ESOP participant's balance must be paid to him or her. Code section 409(o)(1)(C).

Background: The law requires that the distribution of the participant's account be over a period of not less than 5 years if the account value does not exceed $500,000, or 5 years plus 1 year for each $100,000 value, or fraction thereof, the balance exceeds $500,000. The House in adopting the 5 year payment period appears to have done so in recognition that sizeable ESOP accounts, when cashed out, may present a difficult repurchase liability, or demand on corporate cash flow, profits, and assets. If such a demand is unmanageable, the payments to a departing, or a few departing employees, can actually hurt the other ESOP participants who could have their account balances decline as the corporation is weakened by unmanageable repurchase liability.

Problem: It may be more advantageous both to the corporation and to the remaining employees to distribute the amount over a period of less than 5 years.

Solution: Clarify that the 5-year periodic payment requirement allows for more rapid distribution.

Suggestion: Add the phrase "no less rapidly than" to Code section 409(o)(1)(C). Code section 409(o)(1)(C) would therefore read as follows (added words underlined):

"(C) Limited Distribution Period. - The plan provides that, unless the participant elects otherwise, the distribution of the participant's account balance will be <u>no less rapidly than</u> in substantially equal periodic payments (not less frequently than annually) over a period not longer than the greater of -"

Justification: There is no policy reason to require that the distribution period always be 5 or more years.

ESOP Comment 13

Subsection 1174(b) of TRA 86 permits the participant to elect distribution for a period longer than 5 years, or less frequently than once annually. Code section 409(o)(1)(C).

Background: In order to allow both the participant and the plan sponsor a degree of flexibility in making payments over a minimum period of time, the House agreed to allow the participant to elect distribution for a period greater than 5 years.

Problem: As written, subsection 1174(b) may have no limit on the participant's election - i.e., the limit is only his or her creativity.

Solution: Clarify that participant's election only allows choice of options permitted under the plan document.

Suggestion: Add the phrase "other options provided under the plan" to Code section 409(o)(1)(C). This subparagraph of the Code would read as follows (incorporating Comment 12, added words are underlined and deleted words are stricken through):

"(C) Limited Distribution Period. - The plan provides, unless the participant elects <u>other options provided under the</u> plan ~~otherwise~~, the distribution of the participant's account balance will be <u>no less rapidly than</u> in substantially equal periodic payments (not less frequently than annually) over a period not longer than the greater of -"

Justification: Allowing options other than those set forth in the plan document could be problematic if certain creative distribution schemes were permitted.

ESOP Comment 14

Subsection 1174(c) of TRA 86 pertains to the corporation's obligation to honor a put by an employee. Code section 409(h)(5)(A).

Background: In 1978, Congress mandated that an employee, who receives employer stock for which there is no public market, could sell his or her stock back to the ESOP corporate sponsor, and the ESOP sponsor must buy the stock at a fair market value price. This arrangement is the ESOP "put" requirement.

Problem: Code section 409(h)(5)(A) provides that the employer meets its put obligation if it pays for the employee's stock over a period not to exceed 5 years with periodic payments, not less frequently than annually. The literal wording of the subparagraph (A) may preclude the employer from making a lump-sum payment in complying with the put rule.

Solution: Clarify that the 5-year payment rule does not preclude a lump-sum payment.

Suggestion: Add to subparagraph (A) the words "not less rapidly than". Code section 409(h)(5)(A) would then read as follows (added words underlined):

> "(A) the amount to be paid for the employer securities is paid <u>not less rapidly than anually</u> in substantially equal periodic payments (not less frequently than annually) over a period beginning not later than 30 days after the exercise of the put option described in paragraph (4) and not exceeding 5 years, and"

Justification: TRA '86 does not preclude lump-sum payments by ERISA plans. Thus the ESOP sponsor should be able to make lump-sum payments as permitted other ERISA plan sponsors. On page 841 of the Blue Book, a lump-sum distribution is implicitly sanctioned by reference to "total distribution" within a year.

ESOP Comment 15

Subsection 1174(c) of TRA 86 sets forth an adequate security rule for the ESOP sponsor to follow in meeting a put. Code section 409(h)(5)(B).

Background: If the ESOP sponsor honors a put over a multiple year period through periodic payments, its commitment is analogous to the employee having an IOU from its former employer. Congress recognized this debtor-creditor analogy and requires the ESOP sponsor to provide adequate security to the former employee in order to have a reasonable assurance that the ESOP sponsor's obligation will be honored.

Problem: The phrase "adequate security" is not precise, and if interpreted in an unreasonable manner, could result in all lenders to the ESOP being subordinated to the former employee exercising a put that is being paid out over several years. If the former employee has a higher call on corporate assets than other lenders to the corporation, the corporation, in all likelihood, will be impaired in its ability to obtain any kind of financing, either long-term, short-term, bonds, letters of credit, etc.

Solution: Clarify that "adequate security" does not mean a lien on the corporation higher than other corporate creditors.

Suggestion: Include in the Committee Report on S. 1350 that the requirement for adequate security may be satisfied by a device such as a surety bond or letter of credit.

Justification: If the adequate security required causes the ESOP sponsor to impair (or possibly lose) its corporate credit, current ESOP participants will be harmed as surely the value of their stock would decline, perhaps drastically.

ESOP Comment 16

Paragraph 1854(f)(1)(A) of TRA 86, pertaining to voting rights pass through in an ESOP or workers' co-operative (eligible worker-owned cooperative) (EWOC). Code section 409(e)(5).

Background: Because a worker owned co-op does not have percentage voting on governance issues based on corporate shares owned, Congress decided to sanction a 1 vote per participant method for ESOPs and EWOCs as an alternative to percentage, or proportional, voting.

Problem: As written, the new 1-man/1-vote rule may be construed by some to be mandatory.

Solution: Clarify that Congress intended the 1-man/1-vote rule to be an alternative to pass through of voting decisions.

Suggestion: Add the word "also" to paragraph 1854(f)(1(A). Code section 409(e)(5) would then read as follows (added word underlined):

"(5) 1 vote per participant. - a plan <u>also</u> meets the requirements of paragraph (2) or (3) with respect to an issue if -
(A) the plan permits each participant 1 vote with respect to such issue, and
(B) the trustee votes the shares held by the plan in the proportion determined after application of subparagraph (A)."

Justification: As recognized in the Technical Corrections Blue Book, page 162, Congress never intended to mandate 1-man/1-vote for all ESOP corporate sponsors.

ESOP Comment 17

Subparagraph 1854(f)(3)(C) of TRA 86, pertaining to the distribution of employer securities. Code section 409(h)(2).

Background: Among the Congressionally mandated rules governing ESOPs is the rule requiring the ESOP to distribute employer stock, but also allowing a put by the participant of the stock if it is not readily tradeable. Congress has sanctioned that an ESOP sponsor, who wishes to become and/or remain substantially or totally owned by active employees, can require the participant to sell his or her stock back to the ESOP sponsor.

Problem: In clarifying this rule, subparagraph (C) may make it possible for the departed employee to keep the stock, undermining the very purpose of the provision.

Solution: Clarify that an ESOP company can restrict ownership of stock to current employees.

Suggestion: Change the word "may" to "must" in subparagraph 1854(f)(3)(C). Code section 409(h)(2) would then read as follows (added word underlined, deleted word stricken through):

"(2) Plan may distribute cash in certain cases. - A plan which otherwise meets the requirements of this subsection or of section 4975(e)(7) shall not be considered to have failed to meet the requirements of section 401(a) merely because under the plan the benefits may be distributed in cash or in the form of employer securities. In the case of an employer whose charter or by-laws restrict the ownership of substantially all outstanding employer securities to employees or to a trust described in section 401(a), a plan which otherwise meets the requirements of this subsection or 4975(e)(7) shall not be considered to have failed to meet the requirements of this subsection or of section 401(a) merely because it does not permit a participant to exercise the right described in paragraph (1)(A) if such plan provides that participants entitled to a distribution from the plan shall have a right to receive such distribution in cash, except that such plan may distribute employer securities subject to a requirement that such securities ~~may~~ must be resold to the employer under the terms which meet the requirements of section 409(o)."

Justification: The word "may" contradicts the very reason the provision was enacted because it permits a non-employee to retain distributed employer securities, and thereby could result in an employer no longer being substantially (or totally) employee-owned. The current language allows employees to retain the stock. The purpose of the provision is to require them to sell it back to the corporation. Without the "must", Congressional intent would be undone.

ESOP Comment 18

Sections 1132 and 1175 of TRA 86; Code section 41 and 4980(c)(3).

Comment: An employer who transfers excess assets from a terminated defined benefit plan should not be allowed to use those employer securities in order to fund a tax credit ESOP (i.e., when claimed on a carryforward basis).

ESOP Comment 19

Section 111A(g) of S. 1350, relating to section 1133 of TRA 86; Code section 4981A (to be redesignated 4980A by S. 1350.)

Background: Code section 4981A(c)(5) "grandfathers" from the excess distribution tax certain amounts distributed from a plan or plans if (1) an election is made under paragraph (5), and (2) if the accrued benefits as of August 1, 1986, exceed $562,500.

Problem: The "grandfather" is not a true "grandfather" in that it does not exempt individuals from paying the tax, but exempts from the tax only the amount in their account as of August 1, 1986. Thus, in the case of employer securities that appreciate past August 1, 1986, there may be an excess excise tax on that value.

Comment: Although not a technical comment, the ESOP Association takes this opportunity to express once again its strong opposition to the excess excise tax on certain distributions. The Association strongly believes that employee-ownership is to lead to employee-owners getting more than "just a little money". ESOPs are to break the concentration of wealth through widespread ownership of capital. An absolute cap, or a tax on ownership wealth by employees is contrary to the Association's overall position.

We also realize that the TRA 86 "grandather" is for "accrued" benefits as of August 1, 1986, not for individuals and their employer securities as of August 1, 1986. Thus we realize that a suggestion to amend section 4980A(c)(5) to "grandfather" plan accounts, not accrued benefits, would be a substantive change. We do feel such a change, however, would be more equitable than current law.

ESOP Comment 20

Section 111B(h) of S.1350 amending section 1173 of TRA 86; Code sections 133, 851(h) and 852(b)(5)(C).

Note: Subsequent to the technical review of TRA 86 by the Association Advisory Committee, it was noted that certain technical problems may exist that would prevent a mutual fund from holding securities acquisition loans and paying out tax-exempt dividends to one class and taxable dividends to another class of stock. Because section 133 provides that a precise $.50 of every interest dollar is exempt while $.50 is taxable, and because in real economic terms these two income streams are not equal, the mutual fund may desire to price its two classes of shares differently at inception. But serious issues arise under the Investment Company Act of 1940 if redemption prices of the two classes of shares are varied during the life of the fund.

Also, as the relationship between the taxable and the tax-exempt yield curve varies over the term of the loan (as it almost certainly will), it may be impossible to reset properly the interest rates on the two components of the loan (i.e., due to the 50/50 split, either too much tax-exempt or too much taxable interest will be paid).

To solve these problems, the mutual fund may frequently reset the interest rates on the securities acquisition loans. But it may not be possible, under current law, to reset interest rates by the mutual fund because the one-half and one-half requirement under section 133 may not allow a downward adjustment.

A solution may be to allow 50% of the principal of a securities acquisition loan held by a mutual fund with a two-class arrangement to be treated as an obligation described in section 103(a), and the interest attributable to that principal amount would be excludible from income, (thus permitting the interest rates for the two "halves" of a securities acquisition loan to be set separately at existing market rates). This concept already appears in section 852(b)(5)(C)). The revenue impact of such a "fix" should be positive because it should result in the least possible amount of exempt interest being paid.

Finally, section 851(h) treats each fund of a series fund as a separate mutual fund. It may be helpful to clarify that, in the case of securities acquisition loans held by a two-class mutual fund that constitutes a series fund, one fund could be deemed to own the tax-exempt principal portion and one fund the taxable principal portion.

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TESTIMONY ON TECHNICAL CORRECTION

TO THE TAX REFORM ACT

RELATING TO THE FARM CREDIT SYSTEM

Presented by

David Kasten

Summation of Key Points in Farm Credit System Statement

- The Farm Credit System (System) and the farmers and farmer-owned cooperatives it serves are struggling in a severely distressed agricultural environment.
- The U.S. Congress is currently considering a financial assistance package to shore up the System.
- The 1986 Tax Reform Act added approximately $85 million in tax liability to the System.
- This increase in tax liability will have a negative impact on the System's ability to lower interest rates to its farmer borrowers.
- The additional tax burden discourages the building of loan loss reserves at a time when such reserves are critically needed.

Mr. Chairman and members of the subcommittee, my name is Dave Kasten. I am a farmer/rancher from Brockway, Montana, with a small grain and cow/calf operation. I have been a Production Credit Association stockholder for 25 years and a Federal Land Bank stockholder for 16 years. The Farm Credit System helped me get started in farming and develop a sound operation, and I feel an obligation to serve as Chairman of the Board of the Glendive PCA for three and a half years. I was elected to the district board of directors by the Twelfth District PCAs in 1985, and it is my pleasure to represent the Twelfth District and the Farm Credit System at this hearing today.

As a district director I am involved monthly in reviewing the financial condition of each Twelfth District Bank and our Federal Land Bank Association and PCA. Thus, I believe I am well qualified to testify as to the adverse impact on the PCAs and Banks for Cooperatives resulting from the Tax Reform

Act of 1986. As you know, the Tax Reform Act of 1986 repealed the provision of the Internal Code (the Code) that permitted Farm Credit System institutions to utilize the reserve method of accounting for loan losses for tax purposes. Beginning in 1987, System institutions are permitted to claim bad debt deductions only when specific loan losses are realized. In addition, as part of the transition from the reserve method of accounting for bad debts to the specific charge-off method, System institutions will be required to "recapture" their existing loss reserves as income over a four-year period. This will result in increased federal income taxes during the very period when many System institutions are struggling to survive. We do not think it makes any sense from a public policy standpoint to penalize System institutions through changes to the Tax Code at a time when Federal financial assistance is required to ensure the survival of this essential credit delivery system for American agriculture.

However, even if we consider this matter strictly from the standpoint of fairness and equity in the tax system, we believe that there is a compelling argument for correcting the action taken in the Tax Reform Act of 1986 with respect to the System' bad debt reserve deductions. As you will recall, in early 1986 the System brought to the attention of the Senate Finance Committee what we believed to be a major inequity in the tax reform proposal passed by the House of Representatives. The House bill repealed the use of the reserve method for taxpayers generally (including System institutions), but would have essentially preserved the use of the reserve method for small commercial banks and thrift institutions. The System pointed out that there is no sound justification for the disparity of tax treatment between taxable System institutions and small commercial banks (which are our principal competitors) and that this disparity results solely from the fact that neither PCAs nor BCs are technically treated as banks for Federal income tax purposes because they are not authorized to accept deposits.

This Committee and the Full Senate responded to our plea by explicitly preserving the reserve method for taxable System institutions in the Senate's tax reform bill. Quite frankly, we thought that the action of the Senate merely corrected an oversight in the House bill and that we would not be in jeopardy when the tax reform bill went to conference. We were right up until the very end of the conference when in the complicated final compromise agreement apparently there was a decision made to drop this provision of the Senate bill. I say "apparent decision" because the language of the summary of the conference agreement was ambiguous on this issue. It was only after many days had elapsed that we were apprised by the staff that this provision of the Senate bill had in fact been dropped. We have yet to receive a satisfactory explanation of the factors that led to this decision.

Morever, the inequity of which we had complained had in fact become more glaring with the conference agreement because the final tax reform bill recognized the need to defer implementation of the repeal of the reserve method for large troubled banks. Somehow or other, the System seemed to get lost in the larger controversy surrounding the treatment of commercial banks and thrift institutions.

I recount this brief tax history solely to renew our basic contention that System institutions were treated unfairly in the 1986 Tax Reform Bill. System institutions are in fact financial institutions that face the same types of problems as commercial banks. Even though System institutions raise their funds through the public sale of debt securities rather than through the acceptance of deposits there is no basis, in our view, for the disparate tax treatment of their bad debt losses. Certainly System institutions are at least as threatened by loan losses as their commercial bank counterparts. Indeed, because System institutions are authorized only to extend credit to the agricultural sector and thus cannot diversify their loan portfolios, a strong argument can be made that they should have even more tax incentives than commercial banks to build adequate reserves. At a minimum, they should not be penalized.

Again Mr. Chairman, I want to express our appreciation to this Committee for its efforts to address this problem during the consideration of the 1986 tax bill. We appreciate that this issue was not at the top of anyone's agenda when the final decisions concerning that monumental piece of legislation were made. We hope and trust that this Committee will take the opportunity this year to correct a real inequity that resulted from the last minute efforts to achieve agreement on the 1986 tax reform legislation. It is a problem that is very important to the farmer/rancher borrowers of the Farm Credit System and one that we believe can and should be corrected.

THE FARM CREDIT COUNCIL
50 F STREET, NW • SUITE 900 • WASHINGTON, DC 20001 • 202/393-3744

SUMMARY OF JULY 22, 1987 TESTIMONY
ON TECHNICAL CORRECTION TO THE TAX REFORM ACT

Presented by W. M. Harding, President
Central Bank for Cooperatives, Denver, Colorado

Before the U.S. Senate Committee on Finance
Subcommittee on Taxation & Debt Management

o The 12 district Banks for Cooperatives and the Central Bank for Cooperatives provide financial services to about 3,000 farmer-owned cooperatives and rural utility systems throughout the country. The banks currently have about $8 billion in loans outstanding.

o Agricultural cooperatives, rural utility systems, and the Banks for Cooperatives have a significant effect on the rural economy. Most farmers and ranchers are served by a marketing or farm supply cooperative, a rural electric cooperative, a rural telephone cooperative, or another type of farmer-owned cooperative. Many farmers and ranchers depend upon more than one cooperative for supplies or services necessary for their operations.

o The Tax Reform Act of 1986 inadvertently repealed the right of the Banks for Cooperatives and the Production Credit Associations to make deductions to maintain a reserve for loan losses. As a result, these institutions must recapture their reserves accumulated up to December 31, 1986, as income spread over four years, starting in 1987.

o The new tax will have an impact of $54.5 million on the Banks for Cooperatives over the next four years. The total impact on the Production Credit Associations and the Banks for Cooperatives will be about $85 million.

o The new tax penalty on the Banks for Cooperatives will ripple through the rural economy at a time when farmers and ranchers are struggling to survive. Because the Banks for Cooperatives are themselves cooperatives, they will have no choice but to pass the $54.5 million onto their owner-borrowers through higher interest rates. It is estimated that the tax will result in an increase in interest rates of about 20 basis points. Cooperatives, which will be faced with paying the higher interest rates, will be forced to pass the increased costs directly to farmers and ranchers.

o A technical amendment to the Tax Reform Act should be enacted which would allow Farm Credit institutions to continue to utilize the reserve method for losses and, in order to avoid the adverse financial impact on the Banks for Cooperatives and Production Credit Associations, would not require them to recapture reserves created prior to December 31, 1986.

o Allowing Farm Credit institutions to be treated in the same manner as small banks for purposes of establishing reserves would address the technical problem concerning the appropriate code section which should be applied and would avoid the adverse financial impact by not requiring a recapture of a previously accumulated reserves.

Mr. Chairman, I appreciate this opportunity to testify before you today and commend you for providing this forum to discuss a tax issue of importance to American agriculture.

My name is Malcolm Harding. I am president of the Central Bank for Cooperatives in Denver, Colorado, and I am appearing here today as a representative of the Farm Credit System's Legislative Committee.

My testimony concerns the need for a technical correction to the Tax Reform Act of 1986 to extend to the Farm Credit System the same right to use the reserve method of accounting for bad debts as granted to commercial banks of less than $500 million in assets.

I will focus on the impact on the Banks for Cooperatives and its borrowers, and David K. Kasten will discuss the impact on Production Credit Associations and the farmers they serve. The Banks for Cooperatives and the Production Credit Associations are part of the Farm Credit System which has experienced severe financial stress because of economic conditions in agriculture. The System has formally requested that Congress provide financial assistance so that the cooperative lending system can survive and continue to serve rural America.

Let me first provide some background on the Banks for Cooperatives and the cooperatives we serve.
The 12 district Banks for Cooperatives and the Central Bank for Cooperatives provide financial services to about 3,000 farmer-owned cooperatives and rural utility systems throughout the country. The banks currently have about $8 billion in loans outstanding.

The district Banks for Cooperatives are owned by the cooperatives they serve, and the district banks own the Central Bank. The Central Bank buys participations in large loans that exceed a district bank's lending limit. This is an important distinction because the Central Bank for Cooperatives is unique among financial institutions. Our bank does not make direct loans to cooperatives. We simply assist the district banks in meeting the credit needs of large cooperative borrowers.

The net income of the Central Bank is distributed to the 12 district Banks for Cooperatives and constitutes a major portion of the district banks' net income. The district banks distribute their income to the cooperatives which in turn distribute income to their farmer-members. Any impact on the Central Bank's income, such as that posed by the Tax Reform Act, significantly affects all cooperatives that borrow from the Banks for Cooperatives and ultimately the farmer-members of these cooperatives.

Agricultural cooperatives, rural utility systems, and the Banks for Cooperatives have a significant effect on the rural economy. Most farmers and ranchers are served by a marketing or farm supply cooperative, a rural electric cooperative, a rural telephone cooperative, or another type of farmer-owned cooperative. Many farmers and ranchers depend upon more than one cooperative for supplies or services necessary for their operations.

For example, Montana is served by over two dozen rural electric distribution cooperatives which provide electricity to rural areas. These cooperatives obtain their power requirements through ownership of a large generation and transmission cooperative that services rural electric co-ops in seven other states as well.

In addition, Montana has 70 farm supply cooperatives, 27 grain marketing cooperatives, and nine rural telephone co-ops.

It is safe to say that virtually every farmer and rancher in Montana is served by one or more of these cooperatives. In fact, with a cooperative, the users are the owners, so Montana farmers and ranchers have a direct stake in these businesses. It goes without saying that cooperatives are equally as important to farmers and ranchers in other farm states as well.

With this information about cooperatives as the backdrop, I want to briefly discuss the impact of the Tax Reform Act of 1986 on cooperatives that own and borrow from the Banks for Cooperatives.

The Tax Reform Act of 1986 inadvertently repealed the right of the Banks for Cooperatives and the Production Credit Associations to make deductions to maintain a reserve for loan losses. As a result, these institutions would have to recapture their reserves accumulated up to December 31, 1986, as income spread over four years, starting in 1987.

However, the reserve method of calculating bad debts was retained for commercial banks with less than $500 million in assets.

The new tax will have an impact of $54.5 million on the Banks for Cooperatives over the next four years. The total impact on the Production Credit Associations and the Banks for Cooperatives will be about $85 million.

The new tax penalty on the Banks for Cooperatives will ripple through the rural economy at a time when farmers and ranchers are struggling to survive. Because the Banks for Cooperatives are themselves cooperatives, they will have no choice but to pass the $54.5 million on to their owner-borrowers through higher interest rates. It is estimated that the tax will result in an increase in interest rates of about 20 basis points. Cooperatives, which will be faced with paying the higher interest rates, will be forced to pass the increased costs directly to farmers and ranchers.

The Farm Credit institutions clearly need a technical amendment to the Tax Reform Act of 1986.

Farm Credit institutions are truly financial institutions which raise their capital in the public capital markets and which have as their primary function providing credit and other financially related services to their borrowers.

The Tax Reform Act in amending code Section 585 only addressed the treatment of reserve for losses on loans of banks and used the traditional definition of bank as defined in code Section 581 as being an institution "a substantial part of the business of which consists of receiving deposits and making loans and discounts..." Therefore, code Section 585 does not apply to Farm Credit institutions because they are not banks for purposes of the Internal Revenue Code.

Furthermore, as indicated, the intent of Section 805 of the Tax Reform Act of 1986 was clearly to be effective for taxpayers other than commercial banks and by its very terms "taxpayers other than financial institutions."

Because neither cited section addressed the nature of Farm Credit institutions as being truly financial institutions, a technical amendment should be enacted which would allow Farm Credit institutions to continue to utilize the reserve method for losses and, in order to avoid the adverse financial impact on the Banks for Cooperatives and Production Credit Associations, would not require them to recapture reserves created prior to December 31, 1986.

Allowing Farm Credit institutions to be treated in the same manner as small banks for purposes of establishing reserves would address the technical problem concerning the appropriate code section which should be applied and would avoid the adverse financial impact by not requiring a recapture of a previously accumulated reserves.

During these extremely difficult times in American agriculture, the last thing farmers and ranchers and their cooperatives need is another tax to pay.

Mr. Chairman, I understand that you are considering the introduction of legislation to restore the reserve method of calculating bad debts for the Production Credit Associations and the Banks for Cooperatives.

We commend you for your concern for agriculture and rural America, and we urge you to extend your legislation to cover all of the Banks for Cooperatives and Production Credit Associations in the Farm Credit System and not limit it to institutions with less than $500 million in assets.

Three district Banks for Cooperatives have more than $500 million in assets, and the Central Bank has over $5 billion in assets. It is important to recognize that this results from the unique nature of the Farm Credit System. When Congress established the System it established 12 Farm Credit Districts with a Bank for Cooperatives serving each district. The Central Bank was established by Congress to serve all 12 district banks.

Merely because of the regions served by the three district banks these banks have more than $500 million in assets. This is a function of the number of cooperatives and especially the number of large regional cooperatives headquartered in these districts.

Some regional cooperatives serve wide geographic areas that include many states and overlap two or more Farm Credit districts. Nevertheless, a regional cooperative's loans are originated by the district that includes the co-op's home office.

To again use Montana as an example, Montana cooperatives are served, in effect, by two district Banks for Cooperatives and the Central Bank. While Montana is part of the Spokane Farm Credit District, two major regional cooperatives that serve the state are headquartered in the St. Paul district. This is true also for the generation and transmission cooperative that provides the electricity that goes to most of the farms and ranches in Montana.

The Spokane Bank for Cooperatives has less than $500 million in assets while the St. Paul bank and the Central Bank exceed that amount.

Consequently, local cooperatives in Montana borrow from the Spokane bank but the regionals that serve these cooperatives borrow from the St. Paul bank and the Central Bank. The tax penalty would be passed to these co-ops through their regional cooperatives.

In contrast, cooperatives in the neighboring state of North Dakota would feel the impact of the new tax even more because both the local and regional cooperatives in that state are served by the St. Paul bank.

The effect of applying the $500 million cap to the Banks for Cooperatives is to negatively impact all farmers and ranchers served by cooperatives and to more severely impact those who live in the Farm Credit districts served by Banks for Cooperatives having more than $500 million in assets. Obviously, this is neither fair nor reasonable.

I urge the subcommittee to support a technical amendment to restore the reserve method of accounting to the Banks for Cooperatives and the Productions Credit Associations for the benefit of American farmers and ranchers.

Thank you for this opportunity to testify today. I would be happy to respond to any questions.

FCNL EDUCATION FUND

Senator Lloyd Bentsen, Chairman
Senate Committee on Finance
SH-703
Washington, DC 20510

Dear Senator Bentsen:

I am writing to recommend an addition to S.1350, the Technical Corrections Act of 1987, which would make technical amendments in the Tax Reform Act of 1986.

The Tax Reform Act of 1986 treats charitable gift annuities issued by 501(c)(3) organizations as identical to "commercial-type insurance". We believe that this is an error that should be corrected in the Technical Corrections Act of 1987. So far, as we understand it, the bill does not contain language that would correct this error.

Charitable gift annuities do not take the place of commercial annuities in today's market. Commercial annuities are competitive and insurance companies offer rates based on the competitive factor in the market place whereas charitable gift annuities are offered to a much more limited audience, for an entirely different purpose.

The charitable gift annuity is not a competitive instrument; rather it is used as a channel by which an individual contributor can make a significant gift to his or her favorite organization. Our annuitants make their gifts to us based on their commitment to the organization. Most are small contributors who need some income to supplement their retirement funds but who wish at the same time to make a significant gift to our agency. The annuity is the tool that allows them to accomplish both goals. For such small donors the charitable gift annuity is the equivalent of a trust arrangement which is almost exclusively available to wealthy and large donors.

The FCNL Education Fund initiated its annuity program in December 1983 in response to a need expressed by both our volunteer committees and our larger constituency. The program was seen as a tool by which we could build endowment funds while simultaneously offering another way for our contributors to participate in the financial future of the organization. The Gift Annuity is a particularly good device to accomplish that end because it is a simple concept to interpret and understand, can be initiated quickly and easily and can be realistically considered by a large number of our smaller contributors. Our experience indicates that these are all reasons why people choose to use an annuity as a means of support for agencies which they respect. We have also found that many of our contributors have retirement plans or annuity arrangements at their place of work to which they regularly contribute, in much greater amounts and on a steady basis. In contrast to such arrangements they view their gift annuity contribution as just that--a contribution to an organization which has their respect.

We urge you to make the necessary changes in the Tax Reform Act of 1986 to correct this situation and assure that philanthropic organizations can continue to offer gift annuities to their supporters.

Sincerely,

Edward F. Snyder

Edward F. Snyder
Executive Secretary

THE FCNL EDUCATION FUND

The purpose of the FCNL Education Fund is to strengthen the educational and information disseminating role of the Friends Committee on National Legislation. As a 501(c)(3) organization supporting research and education relating to issues of concern to the Religious Society of Friends, the FCNL Education Fund is entitled to receive tax-deductible gifts from individuals and to seek funding from sources such as tax-exempt foundations (IRS ruling of October 1, 1982).

Federation of Bankers Associations of Japan (ZENGINKYO)

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Summary of our Comments

July 21, 1987
Federation of Bankers Associations
of Japan

The Federation of Bankers Associations of Japan, a trade association representing 13 city banks, 64 regional banks, 7 trust banks, and 3 long-term credit banks, wishes to express its deep concern over a provision in the pending Technical Corrections Act of 1987 (hereinafter referred to as the TCA) that would unilaterally override existing U.S. treaty obligations. Enclosed is a letter stating our position in detail.

(1) Our concern is with Section 112(y)(2) of the TCA, which provides that, with certain limited exceptions, the provisions of the 1986 Tax Reform Act will apply notwithstanding any contrary U.S. treaty obligation. As stated expressly in the Joint Committee Print accompanying the proposed legislation, one principal effect of this provision would be to override the protection afforded by treaty nondiscrimination clauses against the so-called " excess interest " component of the branch profits tax enacted in the 1986 Tax Reform Act.

This unilateral override of bilateral tax treaties would have serious repercussions for Japanese banks with U.S. operations. Moreover, such action would inevitably diminish the value of U.S. treaty commitments and impair the goodwill that has developed between the treaty partners. As Treasury Secretary Baker has noted, 1/ creating the perception that the United States is an unreliable treaty partner will severely hamper the ability of the United States to negotiate treaty protection for American companies doing business abroad, and will thus do serious harm to the international competitiveness of American business.

(2) The imposition of branch profits tax including branch-level interest tax on Japanese banks is inconsistent with these articles below of the Japan-U.S. tax treaty.

(Branch profits tax)
- Article 7 paragraph 2 of the Treaty

(Branch-level interest tax)
- Article 6 paragraph 2 and Article 13 of the Treaty
- Article 7 paragraph 2 of the Treaty
- Article 8 of the Treaty

(3) Therefore Japanese banks should be exempt from branch profits tax described in the Section 1241 of the 1986 Tax Reform Act insofar as they are inconsistent with U.S. treaty obligations.

We appreciate your consideration of the points addressed in the enclosed letter.

1/ Letter from Treasury Secretary James A. Baker, III to Senate Finance Committee Chairman Bob Packwood (R-Ore.), April 7, 1986.

Federation of Bankers Associations of Japan (ZENGINKYO)

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Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
The United States Senate
205 Dirksen Senate Office Building
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Comments on Proposed Technical Corrections Act of 1987
(S 1350)

We, the Federation of Bankers Associations of Japan, a trade association representing 13 city banks, 64 regional banks, 7 trust banks, and 3 long-term credit banks, would like to submit our comments on the proposed Technical Corrections Act of 1987 (S 1350) (hereinafter referred to as "the TCA") on behalf of the member banks which have more than 500 offices (branches, agencies, subsidiaries and their branches) in the U.S., as follows.

(1) In line with Section 112(y)(2) of the TCA which states "The following amendments made by the 1986 Reform Act shall apply notwithstanding any treaty obligation of the United States in effect on the date of the enactment of the Reform Act", it appears that foreign tax provisions of the 1986 Reform Act, with some exceptions, shall override tax treaties between the United States and its treaty partners.

Of concern to us is that the branch profits tax which includes branch level interest tax as defined in Section 1241 of the 1986 Reform Act may possibly apply to Japanese banks operating in the U.S. irrespective of the Japan-U.S. Tax Treaty.

We hereby state our opposition to the proposed provisions of the TCA, and we would like to request that the TCA clearly stipulate that the branch profits tax provisions shall not apply insofar as they are inconsistent with U.S. treaty obligations.

(2) The income tax treaty, currently entered into by the United States and 36 countries, is aimed mainly to ensure equal tax treatment for the businesses of a treaty partner country and to avoid double taxation. It also aims at promoting economic transactions, including the mutual flow of capital, between the treaty partners and at promoting the economic development of treaty partner countries.

The imposition of a new tax as proposed in the TCA which unilaterally overrides the tax treaty concluded between the countries concerned will not only diminish the economic value of the tax treaty, but also impair the goodwill that has developed between the treaty partners. Our concern about the application of the override provision was underscored by Treasury Secretary James A. Baker III in his letter of April 7, 1986 addressed to Senate Finance Committee Chairman Bob Packwood saying that "This administration strongly opposes treaty overrides in this tax reform legislation. If the United States makes a practice of unilaterally renouncing its obligations under existing treaties, the value of future treaty commitments from the United States is obviously diminished".

It is our sincere belief that the treaty overrides will cast an added element of uncertainty over the investment climate in the U.S. since foreign banks, which have based their decision to operate in the

U.S. in part on existing income tax treaty provisions, will become subject to the possible risk of being burdened with a tax that is not applicable to U.S. banks.

We fear that this might lead to a scale-down of U.S. operations by foreign banks, which would inevitably result in a reduced flow of capital into the U.S. and less employment opportunities for U.S. citizens. In short, the U.S. economy would suffer adverse repercussions. There is also the ominous prospect of retaliation by treaty partner countries in the form of counter actions on U.S. businesses, a concern also expressed by Treasury Secretary Baker III in his above-mentioned letter.

(3) The imposition of branch profits tax on Japanese banks is inconsistent with the languages of the Japan-U.S. tax treaty as discussed below.

(Branch profits tax)

We are of the opinion that Japanese banks should be exempt from the branch profits tax described in Section 884(a) of the Internal Revenue Code 1986 (hereinafter referred to as "the IRC 1986"), since the tax treaty provisions that allow for such exemption are applicable under Section 884 (e)(2)(B) of the IRC 1986 and since the branch profits tax is considered to be an exception as provided in Section 112 (y)(2)(C) of the TCA which states "Except as provided in the Reform Act ... ".

As the wording of the TCA does not lend itself to a clear interpretation, we request that the provision of the TCA be more specific.

(Branch level interest tax)

The 1986 Reform Act does not explicitly mention who is subject to the branch level interest tax as a taxpayer. Our understanding, however, is that foreign corporations with branches in the U.S. are subject to the tax under Section 884(f)(1) of the IRC 1986.

Although in the Joint Committee on Taxation Staff Description (JCS-15-87) it is stated that the "Act's branch level interest tax provisions are understood to be fully consistent with U.S. treaty obligations", we have concluded that the branch level interest tax is inconsistent with several provisions of the Japan-U.S. Tax Treaty.

The most important point that must be borne in mind for the purpose of analyzing the issue at hand is that a U.S. branch and its head office located outside the U.S. constitute one entity and should not be regarded as separate entities. Following are our analyses on the inconsistencies found between several Articles of the Japan-U.S. Tax Treaty (hereinafter referred to as the "Treaty") and the branch level interest tax provisions.

(A) Article 6 paragraph 2 and Article 13 of the Treaty

Article 6 paragraph 2 and Article 13 of the Treaty cover only instances in which interest is to be paid on transactions between distinct and separate entities. The amount that is subject to the branch level interest tax is that which is calculated on single entity, and should not be considered the interest income as defined in the Treaty.

The imposition of branch level interest tax on such amount is therefore inappropriate.

(B) Article 7 paragraph 2 of the Treaty

Branch level interest tax shall be imposed on foreign corporation as mentioned above. This causes more burdensome tax in addition to the federal corporate tax for foreign corporation. On the other hand, this tax is not imposed on U.S. domestic corporation. It clearly conflicts with the article 7(2) of the Treaty.

According to "General Explanation of the Tax Reform Act of 1986" and "Joint Committee on Taxation Staff Description (JCS-15-87) of Technical Corrections Act of 1987", there seems to be a view that the branch level interest tax is designed to ensure tax collection on interest that is payable through the head office to third party lenders outside the U.S. Although, Section 884 (f)(1)(B) of the IRC 1986 provides that the "foreign corporation shall be liable for tax under Section 881 (a)", the existing legal framework does not allow for foreign corporations on which the tax is imposed to pass it on to third party lenders, if any.

Moreover, if such third party lenders who are interest recipients are exempt from interest tax under the tax treaty between the lenders' home country and the U.S., there will be no way for the foreign corporation to pass on to them the imposed tax.

Therefore, this kind of tax that can not be passed to the final interest recipients is an additional tax imposed upon foreign corporations themselves, and therefore, violates the non-discriminatory clause of the Treaty both literally and substantially.

(C) Article 8 of the Treaty

Branch level interest tax is an additional tax on a part of the amount which has already been conceded as deductible expenses when calculating the taxable income of the U.S. branch. This is a denial of the authorized calculation method of taxable income gained by U.S. operations, and is inconsistent with Article 8 of the Treaty which allows expenses to be deducted when calculating taxable income earned by the permanent establishment.

We, the Federation of Bankers Associations of Japan, strongly request that above-mentioned points be carefully considered, and that appropriate amendments of the TCA be made.

Sincerely yours,

K. Kamiya

Kenichi Kamiya
Chairman
The Federation of Bankers
Associations of Japan

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July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987

Dear Mr. Leonard:

Enclosed herewith is a statement submitted on behalf of Federal Express Corporation commenting upon the proposed Technical Corrections Act of 1987.

This statement discusses problems caused by the amendment to section 48(d)(5) of the Internal Revenue Code of 1986 which will require the inclusion in income of 100% of investment tax credit claimed by lessees (as opposed to the 50% amount as required by the Tax Reform Act as enacted). While the corrective nature of this amendment as enacted by the 1986 Tax Reform Act is understood, the amendment causes severe financial reporting problems as explained in the attached statement.

We appreciate the opportunity provided by the Committee to comment upon this legislation.

Very truly yours,

Charles L. Almond

Enclosures

M E M O R A N D U M

July 17, 1987

Coordination of Rules Allowing ITC Pass-Through to Lessees with ITC Basis Adjustment (Section 48(d)(5) of the Internal Revenue Code of 1986 and Section 102(e) of the Technical Corrections Bill of 1986)

Section 103(e) of the Technical Corrections Bill amends section 48(d)(5) of the Internal Revenue Code of 1986 to require lessees to whom investment tax credit ("ITC") is passed through under the provisions of section 48(d) to include 100% of the amount of the ITC in income ratably over the shortest recovery period of the subject property. Under the Tax Reform Act of 1986, as enacted, lessees were required to so include only 50% of the ITC amount.

Although the corrective nature of this proposed amendment from the federal government's point of view is understandable, the fact and timing of the correction creates serious problems for publicly-held corporations which, under financial accounting rules, are required to report earnings to shareholders on the basis of the law as it exists without regard to pending legislation. Therefore, if this amendment is enacted, a company that has placed transition property in service in periods for which financial reports have already been prepared and dessiminated will show an aberational negative impact on earnings which is not readily explicable to shareholders and other persons who rely on financial statements in dealings with the company. This can clearly have a detrimental effect on a company's ability to raise capital.

Therefore, we request the opportunity to discuss and explore possible solutions to the problem created by this proposed amendment.

Supplemental Information

This statement is submitted by John E. Chapoton and Charles L. Almond of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C., 20004-1007, telephone number (202) 639-6500, on behalf of FEDERAL EXPRESS CORPORATION.

Hearing on S. 1350, The Technical Corrections Act of 1987

SUMMARY

LAWRENCE J. WHITE
BOARD MEMBER
FEDERAL HOME LOAN BANK BOARD

In the Tax Reform Act of 1986, Congress decided to continue, through the end of 1988, the prior law relating to FSLIC-supervised acquisitions. This policy meant preserving the special qualifying reorganization rules in section 368(a)(3)(D)(ii), the tax attribute rules of section 382, and the treatment of FSLIC assistance payments in section 597. Neither the Conference Report nor the "Bluebook" prepared by the staff of the Joint Committee on Taxation expresses any intent to alter the FSLIC tax provisions in any substantive way.

The Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation request the Committee on Finance to include three technical amendments to S. 1350. These amendments relate to new Code section 382 as follows:

1. Preserve a rule of prior law, former section 382(b)(7)(B), benefitting tax attributes in FSLIC mergers, which seems to have been omitted inadvertently in the 1986 Act. Under this rule, net operating loss (NOL) carryovers were fully preserved in a supervisory merger of a failed thrift if the acquired thrift's deposits comprised at least 20% of the combined deposits of the combined institution after the merger. If this level was not attained, the carryovers were "scaled down" by 5% for each 1 percentage point below 20% represented by the transferred deposits. The 20% "cliff" created by the 1986 Act frequently conflicts with the safety-and-soundness concerns of the FSLIC in supervising and assisting the acquisition of troubled thrifts. The problems of these institutions are frequently best absorbed by comparatively large acquirers, but the 20% "cliff" may impede these mergers. The "slope" or scaling of the prior law, if reinstated, would be less of an impediment.

2. The two-year provision of new section 382(l)(5)(D) was not intended to apply to a FSLIC-supervised acquisition. This provision could totally eliminate NOL carryovers in a FSLIC-supervised acquisition of an insolvent thrift where the thrift's assets are first conveyed to an "interim" savings and loan association created and operated by the FSLIC while a buyer is sought and then a buyer acquires control of the interim association. The two-step format in FSLIC transactions where an interim thrift association is created is not part of any arrangement involving potential abuse. The two-year rule appears to have been developed in order to prevent creditors of a bankrupt regular corporation from becoming shareholders of the corporation, preserving NOL carryovers for their ultimate benefit, but thereafter selling off their stock to third parties who are strangers to the company and whose money did not finance the operating losses.

3. Eliminate the differential tax treatment, within the scope of a special two-year "window" for mutual-to-stock thrift conversions, of certain formalistic mechanics for accomplishing a conversion that apparently were not focused on when new Code section 382 was drafted.

Mr. Chairman, Members of the Subcommittee:

I am pleased to be here this morning, and I thank you for the opportunity to present the comments of the Federal Home Loan Bank Board ("Bank Board") and the Federal Savings and Loan Insurance Corporation ("FSLIC") regarding S.1350, The Technical Corrections Act of 1987. We are proposing three technical corrections to new Code section 382 (relating to limitations on net operating loss carryovers and other tax attributes following a corporate reorganization) as enacted by the Tax Reform Act of 1986. Our proposals supplement the helpful corrections already included in S. 1350, as introduced.

In the Tax Reform Act of 1986 ("1986 Act"), Congress decided to continue the entire group of tax provisions dealing specifically with FSLIC transactions but to subject them to review at the end of 1988. The 1986 Act thus "sunsets" the FSLIC provisions at the end of 1988, thereby enabling Congress to review the continued need for the provisions beyond that period. However, we have identified three items that we believe are wholly technical in nature. They contain no hidden effects or changes for FSLIC transactions, and we believe that they pose no problem with respect to the harmonization of the treatment of those items alongside the unaffected provisions of the 1986 Act.

1. <u>20% deposit continuity test for NOL carryovers</u>.

Under prior law, in a supervisory merger of a failed thrift, net operating loss (NOL) carryovers were fully preserved if the acquired thrift's deposits comprised at least one-fifth (20%) of the combined deposits of the combined institution after the merger. If this level was not attained, the carryovers were "scaled down" by 5% for each 1 percentage point below 20% represented by the transferred deposits. (Former sec. 382 (b)(7)(B)). This provision treated thrift deposits as stock for purposes of qualifying under the general rule of prior sec. 382(b). That general rule, applying to all reorganizations, preserved the full dollar amount of NOL carryovers if "shareholders" of the loss company received stock worth 20% or more of the value of all the stock of the combined company. If the 20% level was not attained, the scaledown formula applied, that is, the carryover dollar amount was reduced by 5% for each 1 percentage point below the 20% level.

In the Tax Reform Act of 1986, Congress decided to continue, at least through the end of 1988, the prior law relating to FSLIC-supervised acquisitions. This policy meant preserving the special qualifying reorganization rules in sec. 368(a)(3)(D)(ii), the tax attribute rules of sec. 382, and the treatment of FSLIC assistance payments in sec. 597. Neither the Conference Report nor the "Bluebook" prepared by the staff of the Joint Committee on Taxation expresses any intent to alter the FSLIC tax provisions in any substantive way.

The statute itself, however, does not contain the graduated scaledown of tax attributes where the 20% deposit proportion is not attained in a FSLIC-supervised acquisition. As a result, the NOL carryovers would be severely limited in those cases after the merger. The annual limitation on utilizing the defaulted thrift's tax attributes would come into play, creating a large "cliff" depending on whether the 20% proportion is met or missed, even barely. This inadvertent omission in the statute creates undesirable difficulties for the Bank Board and the FSLIC. On one hand, it tends to discourage the very type of acquisition which FSLIC encourages, namely, very large acquirers agreeing to rescue smaller institutions. Larger acquirers offer better prospects of rehabilitating a troubled institution. On the other hand, if the tax rules compel the FSLIC to locate acquirers that are not so big as to trigger the "cliff" -- because the 20% deposit ratio will not be attained -- the Bank Board has regulatory concerns over the safety and soundness of the acquisition. The tax rules should not place the federal regulator in such a difficult position.

In a sample of eleven FSLIC-assisted mergers completed in 1986 and 1987, six of the mergers did not meet the 20% ratio. If these six mergers were subject to the statute as it now reads, the NOL carryovers would be lost as a result of the "cliff," and FSLIC would not receive any related benefit. Furthermore, in one of the five mergers that did meet the 20% ratio the asset mix was intentionally rearranged in order to preserve $200 million in NOL carryovers. In addition, a primary reason a pending merger has been delayed is to consider ways to rearrange the deposit ratio in an attempt to preserve $110 million in NOL carryovers.

The scaledown rule of prior law was not ambiguous or difficult to apply. It was part of the prior tax rules that applied to assisted thrift mergers and should be restored to current law, as Congress intended.

2. Possible complete extinguishment of NOL carryovers where FSLIC creates an "interim" association.

Under the 1986 Act, a second reorganization occurring within two years after a first reorganization extinguishes NOL carryovers in toto for the years following the second reorganization (sec. 382(1)(5)(D)).

This provision could totally eliminate NOL carryovers in a FSLIC-supervised acquisition of an insolvent thrift where the thrift's assets are first conveyed to an "interim" savings and loan association created and operated by the FSLIC while a buyer is sought, and then a buyer acquires control of the interim association. In private tax rulings IRS has treated these steps under prior law as two successive type (G) reorganizations. See PLR 8411060 (Dec. 14, 1983). This two-step format would not have had any adverse effect on NOL carryovers under prior law, because no penalty arose based on a short time period between successive reorganizations.

The two-step format in FSLIC transactions where an interim thrift association is created is not part of any arrangement involving potential abuse. The two-year rule in new sec. 382 appears to have been developed in order to prevent creditors of a bankrupt regular corporation from becoming shareholders of the corporation, preserving NOL carryovers for their ultimate benefit, but thereafter selling off their stock to third parties who are strangers to the company and whose money did not finance the operating losses. FSLIC transactions are altogether different. An interim thrift association is created by the FSLIC in receivership situations where it is essential to protect depositors in the defaulted institution and quickly remove assets and liabilities to a more secure corporate entity. To achieve this objective, if an ultimate buyer for the institution has not been located at the time the failed thrift is placed in receivership, the FSLIC may create a newly chartered Federal mutual savings and loan association to receive assets and deposit liabilities, and to operate thereafter with new management, until an ultimate purchaser can be found. The selection of a purchaser may itself involve a period of time consisting of an invitation for proposals from interested potential purchasers and, after acceptance of a particular proposal, negotiation of an assistance agreement with the FSLIC. In substance, the creation of the interim mutual association is a holding action, and the purchaser's acquisition of the interim association is the true acquisition.

Therefore, the Board believes that the two-year provision of new section 832(1)(5)(D) was not intended to apply to, and ought not apply to, a FSLIC-supervised acquisition that may involve a "holding" entity. Such a two-year rule was not a part of prior law and should not now be imposed as a new obstacle in view of Congress' policy to continue the prior law as it applied to FSLIC transactions.

In accord with Congress' policy to maintain prior law through 1988, the two parts of a supervisory acquisition should not cause any loss of tax attributes.

3. Public offerings of stock in a thrift converting from mutual to stock form.

Sec. 621(F)(4) of the Tax Reform Act of 1986 effectively prevents the new limitations on NOL carryovers from applying to public offerings of stock in a savings and loan association that is converting from mutual to stock form during 1987 and 1988. The transition rule exempts from the definition of an equity structure shift in new sec. 382 a public offering "with respect to domestic building and loan transactions * * *." This "window" clearly applies to a mutual thrift issuing its stock directly to the public.

Three other mechanical ways to convert a thrift from mutual stock form should also be covered under the special two-year "window":

(1) A "merger conversion," where a mutual S&L or savings bank merges into a newly-created or existing S&L, and a public offering is made of stock in the acquiring association;

(2) A "holding company conversion," where a holding company purchases all the conversion stock and makes a public offering of stock of the holding company; and

(3) A "holding company conversion" where the mutual merges into a newly-created or

existing S&L that is a subsidiary of a savings and loan holding company, and the public offering is made of stock of the holding company (rather than of the subsidiary itself).

The IRS has issued numerous private letter rulings approving all three types of conversions as taxfree reorganizations. However, under the new NOL carryover restrictions the first and third formats would technically be classified as equity structure shifts, which in turn will cause NOL carryovers to be limited under the new general rule, i.e. only a small percentage of the NOL carryover can be utilized each year.1/ It is unclear, as the Board reads the language of Section 621(f)(4) of the Tax Reform Act, whether the phrase "domestic building and loan transactions" extends to a conversion by merger with a different corporate entity and a public offering of stock in the acquiring entity or in a holding company which is the parent of the acquiring entity.

If a holding company buys the conversion stock and then sells stock in the holding company (Situation (2)), it is also unclear whether the public offering is a "domestic building and loan transaction" within the meaning of the two-year window.

The mechanical form of accomplishing a mutual-to-stock conversion should not be significant. Allowing form to prevail over substance will inhibit the FSLIC's capital-raising goal to forestall defaults and attract private capital into the thrift industry. The conversion formats described above should be equally protected under the two-year exemption in Sec. 621(f)(4) of the Tax Reform Act for thrift conversions during 1987 and 1988.

A revision of the language of Sec. 621(f)(4) of the Tax Reform Act, as proposed in H.R. 2636, also seems uncertain with respect to covering the conversion mechanics described above. The bill (sec. 106(d)(15)) would substitute a reference to "institutions described in section 591 of such Code with respect to any public offering before January 1, 1989." This language seems literally inapplicable to a public offering of stock in a holding company that is not itself a thrift institution. The language is also ambiguous with regard to whether it refers only to a public offering of stock in the mutual entity itself, or also to a public offering of stock in an entity which acquires assets of the converting institution by means of a statutory merger.

The Board and the FSLIC welcome the three items referred to below that are already included in S. 1350, as introduced.

First, for purposes of the survival of NOL carryovers, the 20% deposit proportion test will be calculated solely by reference to the value of the deposits and not by requiring savings deposits to possess voting power. Section 106(d)(8)(A), Technical Corrections bill.

Second, a firm commitment underwriting in connection with a public offering of stock in a converting mutual savings and loan association is protected against reduction in NOL carryovers under the two-year "window" for thrift public offerings during 1987-88. Sec. 106(d)(15), Technical Corrections Bill.

Third, savings banks, in addition to savings and loan associations, are included in the two-year "window" for NOL carryovers in thrift public offerings during 1987-88. Sec. 106(d)(15), Technical Corrections Bill.

1/ The general rule of sec. 382 would govern because, under the rules, investors in the public offering would be viewed as causing a greater-than-50% change in the ownership of the converting mutual association. This result would occur pursuant to new sec. 382(g) (4) (B) (i), which in the case of a merger involving two distinct corporations, segregates the shareholders of each separate company in calculating whether an ownership change has occurred.

SUPPLEMENTAL SHEET
COMMENTS OF FIDELITY INVESTMENTS
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
REGARDING
TECHNICAL CORRECTIONS ACT OF 1987

Summary of Comments

1. Description of the Short-Short Gain Test

   Code section 851(b)(3) provides that a corporation will not be eligible for the pass-thru treatment afforded RICs under Subchapter M unless less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than three months.

2. Expanded Definition of Short-Short Gain

   Section 106(n)(2) of S. 1350 would amend section 851(b)(3) to provide that short-short gain would include, in addition to gain from stock and securities, gain from foreign currencies (except as provided in regulations), options, futures and forward contracts held for less than three months.

3. Procedural Considerations

   a. The expansion of the short-short test to include gain from investments which are not stock or securities is not a technical correction to the Tax Reform Act of 1986 but rather is a significant modification and expansion of its provisions. Such changes should only be considered as part of future legislation.
   b. If enacted, the proposed change could result in such gains being retroactively recharacterized as short-short gains. If these changes are adopted as part of the Act, they should be effective for tax years of RICs beginning after the date of enactment of the Act.

4. Business of Investing Exceptions

   In the event that a modification of the short-short test is deemed to be necessary, gains related to a RIC's business of investing in stocks or securities should be excepted from the short-short test.

5. Regulatory Issues

   In the event that the expansion of the short-short test is adopted without the statutory exceptions described above, the Secretary should be provided with regulatory authority to make exceptions for gains from options, futures and forward contracts relating to foreign currencies as well as transactions in foreign currencies.

6. Treatment of Section 988 Gains

   Alternatively, S. 1350 could be amended to provide that for purposes of section 851(b)(3) of the Code all foreign currency gain or loss from a section 988 transaction should be considered as interest income or interest expense, while providing the above described regulatory exceptions for all transactions not covered by such legislative relief.

Fidelity Investments

Robert C Pozen
Senior Vice President

Ms. Laura Wilson
Hearing Administrator
United States Senate
Committee on Finance
Room SD-205
Dirkson Senate Office Building
Washington, DC 20510

Dear Ms. Wilson:

I am writing this letter to you to express the concerns of Fidelity Investments over certain of the changes to Internal Revenue Code ("Code") Section 851(b)(3) which are contained in the Technical Corrections Act of 1987 - H.R. 2636 and S.1350 ("the Act").

Fidelity Investments is a diversified financial services business which at present is the manager of regulated investment companies (RICs) and other accounts for over 3 million investors with over $80 billion under management.

The Short-Short Gain Test

Section 851(b)(3) of the Code provides one of the requirements which a corporation must meet in order to be treated as a RIC. At present, it provides that a corporation will not be eligible for the pass-thru treatment afforded RICs under Subchapter M unless less than 30 percent of its gross income is derived from the sale or other disposition of stock or securities held for less than three months. Such nonqualifying gain is generally referred to as "short-short gain" or "short three gain". It has been stated that the purpose of the short-short gain rı is to prevent the portfolio managers of RICs from churn. the portfolios.

The Expanded Definition of Short-Short Gain

Section 106(n)(2) of the Act would amend Section 851(b)(3) to provide that short-short gain would include, in addition to gain from stocks and securities, gain from foreign currencies (except as provided in regulations), options, futures and forward contracts held for less than three months. Our concerns principally relate to the application of this expanded definition of the Act to those RICs which invest primarily in securities of foreign issuers, the purchase and sale of which are denominated in currencies other than the U.S. dollar.

Procedural Considerations

We believe that the expansion of the Section 851(b)(3) test by Section 106(n)(2) of the Act to include gain from investments which are not stock or securities is not a correction of the Tax Reform Act of 1986 but rather is a significant modification and expansion of its provisions. We believe that such substantive changes should not be part of the technical correction effort which is currently being undertaken. Rather such changes should only be considered as part of future legislation.

As presently drafted, the Section 851(b)(3) changes would be retroactive in their application to taxable years beginning after the date of enactment of the Tax Reform Act of 1986 - October 22, 1986. Such retroactive application could result in disqualification of many RICs for pass-thru treatment under Subchapter M of the Code. Relying on Section 851(b)(3) as presently constituted, RIC's may have realized substantial gains from transactions in foreign currencies. If enacted, the proposed change could result in such gains being retroactively recharacterized as short-short gains. These funds may now find it virtually impossible to maintain qualification as a RIC for their current fiscal year - a result solely attributable to this retroactive application of the change.

It is our view that it is not sound tax policy nor would it be fair to RIC shareholders to retroactively apply such substantive changes to Section 851(b)(3) as those proposed by Section 106(n)(2) of the Act. Therefore, if these changes are adopted as part of the Act, they should be effective for tax years of RICs beginning after the date of enactment of the Act.

<u>Business of Investing Exceptions</u>

In the event that a modification of the short-short test is deemed to be necessary, we believe that an exception should be provided for certain gains from foreign currencies and gains from options, futures and forward contracts related to foreign currencies. We recommend that such gains, to the extent that they are related to a RIC's business of investing in stocks or securities, be excepted from the short-short test.

Congress clearly recognized that such business related income should be considered qualifying income for purposes of Section 851(b)(2) when it passed the Tax Reform Act of 1986. Section 653(b) and (c) of the Tax Reform Act of 1986 expanded the definition of qualifying income to include, in addition to dividends, interest, income from security lending and gains from stock and securities transactions:

- other income including gains from options, futures and forward contracts derived with respect to its business of investing in stock or securities, and

- gains from foreign currency except to the extent determined under regulations to be not directly ancillary to a RIC's business of investing in stock or securities.

We believe that Congress should expressly establish similar exceptions to the short-short rule for gains from foreign currencies and foreign currency related options, futures and forward contracts. We recognize that Section 106(n)(2) of the Act does provide Treasury with regulatory authority to except foreign currency transactions from the short-short rule. However, we believe that such an exception is so important that it should be contained in the Act itself and should not be delayed unless and until Treasury issues appropriate regulations.

In any event, Section 106(n)(2) does not provide Treasury with regulatory authority to except from the short-short rule gains from options, futures and financial contracts in foreign currencies. The use of such derivative instruments is often a more efficient and effective method of minimizing exposure to foreign currency fluctuations than by buying and selling the actual currency. As a result, we advocate that the exception apply to such instruments as well as foreign currencies.

The proposed expansion of the short-short test without the business of investing exceptions could require a corporation to take undue speculative risk in the foreign currency markets so as to meet the short-short test and maintain its

RIC status. This is clearly inconsistent with the stated purpose of Section 851(b)(3).

Regulatory Issues

In the event that the expansion of the short-short test is adopted without the statutory exceptions described immediately above (i.e., the business of investing exceptions), we believe that new Section 851(b)(3)(B) should provide the Secretary with regulatory authority to make exceptions for gains from options, futures and forward contracts relating to foreign currencies as well as transactions in foreign currencies.

We believe that Congress should make it clear that these regulations should provide a broad ancillary business exception for gains from foreign currency and for related options, futures and forward contracts. For example, exceptions should be provided for gains from temporary foreign currency holdings, and gains resulting from settlement of security purchases and sales and related options, futures and forward contracts.

In a related matter, Section 851(g) provides, in certain circumstances, a RIC with the ability to net gains and losses on hedged positions for short-short gain purposes. It appears that hedging transactions utilizing futures or forward contracts may not qualify for this netting treatment unless specifically provided for under regulations to be issued pursuant to Section 851(g)(2)(A)(iii). We believe that futures and forward contracts, being standard hedging instruments, are eligible for Section 851(g) netting treatment. However, to eliminate potential uncertainty in this area Congress should confirm that futures and forward contracts are to be included in the definition of "other positions" as used in Section 851(g)(2)(A)(iii).

Treatment of Section 988 Gains

Almost all of the above described transactions, except for those involving Section 1256 contracts, also are considered transactions under Section 988 of the Code. Therefore, as an alternative approach, Congress could enact appropriate relief for short-short gains in connection with Section 988 transactions, while providing the above described regulatory exceptions for all transactions not covered by such legislative relief.

RICs which invest in foreign currency denominated securities can generate gain from Section 988 transactions as defined in Section 988(c) of the Code. All or a part of such gain may constitute foreign currency gain as defined in Section 988(b) of the Code. Such foreign currency gain or loss attributable to a Section 988 transaction is generally treated as ordinary income under Section 988(a)(1)(A) of the Code To the extent provided in regulations, such ordinary income or loss is to be treated as interest income or expense for certain purposes.

It is our view that the Act should be amended to specifically provide that for purposes of Section 851(b)(3) of the Code that all foreign currency gain or loss from a Section 988 transaction should be considered as interest income or interest expense. The basic rationale behind Section 988 is that there is a direct relationship between the movement of foreign exchange rates and interest rates. In fact, the House of Representatives version of Section 988 specifically treated foreign currency gains and losses as interest income and interest expense. However, the Tax Reform Act of 1986 in the final version left such interest characterization to regulatory authority.

If blanket treatment of Section 988 foreign currency gains and losses as interest income and expense is not adopted, it is our view that as a minimum certain specific gain or loss transactions should be given such interest characterization.

Specifically, interest treatment should be provided for:

- gain or loss attributable to the disposition of an investment by a RIC in a foreign currency which was held pending the purchase of a foreign security;
- gain or loss attributable to interest or dividends receivable which are payable in a foreign currency;
- gain or loss attributable to the sale or disposition of a debt instrument;
- gain or loss attributable to the disposition of forward contracts (which are not Section 1256 contracts) relating to foreign currencies.

It is our view that such treatment is consistent with the rationale behind Section 988. Moreover, it would be inconsistent with the objectives of Section 851(b)(3) to jeopardize a RIC's status as a result of gains which could arise from such purely passive non-speculative investment activities.

If you wish to discuss any of these matters further, or have any questions regarding them, please do not hesitate to call me.

Sincerely,

Robert C. Pozen

Robert C. Pozen

James C. Gould, Esq.
Chief Tax Counsel
United States Senate
Committee on Finance
205 Dirksen Senate Office Building
Washington, D. C. 20510

Re: Technical Corrections Act of 1987

Dear Mr. Gould:

In response to Chairman Bentsen's invitation for comments on the proposed Technical Corrections Act of 1987 (H.R. 2636, S. 1350), as introduced on June 10, 1987, (the "TCA"), I am writing to recommend that the bill include a technical correction in Section 1131 of the TCA, relating to adjustments to the deduction limitations under Section 404 of the Internal Revenue Code of 1986 (the "Code"). The requested correction relates to the application of Section 404 in the context of multiple employer plans described in Section 413(c) of the Code.

The Financial Institutions Retirement Fund (the "Fund") is a Section 413(c) multiple employer plan. The Fund was established in 1943 to provide retirement and certain other benefits for the eligible employees of the Federal Home Loan Banks, and other financial institutions and those organizations serving them.

Under Section 413(c)(6) of the Code, the deductible limits for Section 413(c) plans are calculated by aggregating all participants of the plan and treating them as if employed by a single employer, with the consequence that all employers contributing to the plan are aggregated and treated as a single employer. When a Section 413(c) plan is subject to the full funding limitation imposed under Section 404 of the Code, no deductible contributions to the plan may be made by any employer and a 10% excise tax will be imposed on any nondeductible contributions which might be made. This effectively precludes the Fund from collecting contributions from certain employers who have only recently begun participating in the Fund who should otherwise be required to contribute to fund the liabilities attributable to their employees, allowing these employers to provide plan benefits for their employees at the expense of those employers whose participation in the Fund over the long term has contributed to the fully funded status of the plan. This is also a serious deterrent for any new employers who might otherwise wish to provide retirement benefits to their employees by joining the Fund.

I have enclosed a position paper describing the issue in more detail, as well as proposed statutory language. We believe that Congress did not intend to adversely impact Section 413(c) multiple employer plans, and respectfully request your consideration in correcting the technical problem.

We would like to meet with you and others on the Senate Finance Committee staff at your convenience to discuss the issue and to respond to any questions you may have. We will be calling your office to arrange for such a meeting.

Respectfully submitted,

John W. Bagwill, Jr.

John W. Bagwill, Jr.
President
Financial Institutions
Retirement Fund

Impact of Full Funding on Financial Institutions Retirement Fund

Background

In 1943, the Federal Home Loan Banks and a group of savings and loan institutions established a not-for-profit organization, the Financial Institutions Retirement Fund, which designs and administers benefit plans for employees in the thrift industry. The organization administers two basic programs, the Financial Institutions Retirement Fund (the "Retirement Fund") and the Financial Institutions Thrift Plan.

The Retirement Fund is a multiple employer, single defined benefit plan under section 413(c) of the Internal Revenue Code which allows participating employers to design a normal retirement income for employees at age 65 in accordance with the benefit formula adopted by the employer. In addition to basic normal and early retirement benefits, there are other options available such as death and disability coverage, increased early retirement incomes and post retirement cost-of-living adjustments. The Retirement Fund provides coverage for over 26,000 active employees and 6,600 retirees of nearly 500 employers. The Retirement Fund serves primarily smaller employers for which the costs of a separate plan would present an impediment to the establishment of a pension plan. Nearly half of the employers participating in the Fund have 20 or fewer employees and three-fourth have 50 or fewer employees. The Retirement Fund's economies of scale result in reduced administrative expenses which permit many small employers to maintain defined benefit plans for their employees that might otherwise be too costly or administratively burdensome to maintain on an individual employer basis.

As a multiple employer plan, the Retirement Fund is viewed as a single plan for purposes of the annual limitation on deductible contributions. Under applicable law, no tax-deductible contributions may be made to a qualified plan when the plan is in full funding and any nondeductible contributions which are made will be subject to a 10 percent excise tax. Due to favorable investment experience, the Retirement Fund, when viewed as a single plan, is in full funding for the first time for the plan year commencing on July 1, 1987. There is a 50 percent probability that the Retirement Fund will remain in full funding for a period of 6 years.

Issues

Although the Fund is in full funding, the plans of certain participating Retirement Fund employers, when viewed separately, might not be in full funding. Nevertheless, such an employer would not be able to make a tax-deductible contribution to the Retirement Fund and thus will not be funding the employer's share of the Fund's actuarial liability.

Prior to the Tax Reform Act of 1986, a participating employer could have made a non-deductible contribution to the Retirement Fund. The 10 percent excise tax on non-deductible contributions imposed by the 1986 Act now effectively precludes the Retirement Fund from collecting such contributions.

These limitations prevent the Retirement Fund from properly serving the thrift industry and the Fund has actually suspended all contributions. The Retirement Fund will not be able to take contributions from employers whose plans, when viewed separately, are not in full funding. Typically, these would be employers who recently have joined the Retirement Fund, or have improved the level of benefits under the Retirement Fund. In addition, new employers will be excluded from the Retirement Fund by their inability to make tax-deductible contributions.

Proposed Solution:

Section 413(c) should be amended to permit a multiple employer plan to irrevocably elect to apply the annual limitation on deductible contributions on an employer-by-employer basis. This election would only be available when the procedures of the plan permit the determination of separate funding requirements and those requirements form the basis for actual contributions. A conforming adjustment to the minimum funding standard would also result from the election. However, a multiple employer plan making the election would continue to be treated as a single plan for all other purposes as under present law.

Discussion:

The Retirement Fund, due to the special nature of the services it provides and its economies of scale, enables many small employers in the thrift industry to provide retirement programs for their employees when it would be too costly to do otherwise. The Retirement Fund contains many features such as portability and improved benefit security which support the policies embodied in recently enacted and proposed pension legislation. The proposed amendment will permit (1) new employers to participate in the Retirement Fund while the Retirement Fund is in full funding by virtue of contributions by others and (2) a more equitable allocation of cost of benefits among participating Retirement Fund employers. Under the amendment, when the plan is not in full funding, employers who would be in full funding if viewed separately would not be permitted to make deductible contributions.

Amendment Relating to Multiple Employer Plans

Viz:

Section 413(c)(4) is amended by striking "The minimum" and inserting in lieu thereof: "Except as provided in paragraph (7), the minimum"

Section 413(c)(6) is amended by striking "Each applicable" and inserting in lieu thereof: "Except as provided in paragraph (7), each applicable"

Section 413(c) is amended by adding at the end thereof the following new paragraph:

"(7) Election.--In the case of any 'qualified electing multiple employer plan,'

(A) each applicable limitation provided by section 404(a) shall be determined

(i) by treating (solely for purposes of section 404(a)) each employer's participation in the plan as the establishment and maintenance of a separate defined benefit plan described in section 401(a) covering only its own employees, and

(ii) by allocating to each such separate plan a share of assets and liabilities determined by applying the method specified by the planfor determining the amount of plan assets and liabilities which would be transferred to a successor plan of a withdrawing employer, and

(B) the minimum funding standard provided by section 412 shall be determined by allowing as a credit under section 412(b)(3) the amount of any charges less credits to the funding standard account under section 412(b) with respect to which a deduction would be disallowed under section 404(a) by reason of the application of subparagraph (A) of this paragraph.

(C) For purposes of this paragraph, a 'qualified electing multiple employer plan' is any plan to which this subsection applies and which has elected the application of this paragraph in the form and manner provided for by the Secretary.

The election provided by this paragraph shall be revoked only with the consent of the Secretary."

Effective date.--The election provided under section 413(c)(7) of the Internal Revenue Code of 1986 shall be available with respect to the plan year which includes the date of enactment of this Act or any subsequent plan year.

F

Grace Brethren

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July 15, 1987

Laura Wilcox
US Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Laura Wilcox:

We are very concerned that the Technical Corrections Act which has just been introduced has not clarified the gift annuities question.

Would you please do everything you can to see that this act states that gift annuities are not treated as "commercial-type annuities" under the I.R.C. Section 501 (m).

The monies we receive from gift annuities are an important element of our gift income because of our donors' interest.

We follow the standard program of the Committee On Gift Annuities and are not in competition with "commercial-type insurance" annuities.

We have used these gift annuities for many, many years. They are a way for small donors to participate in a charitable life income arrangement who do not have sufficient funds to establish a charitable remainder unitrust or a charitable remainder annuity trust. These latter two are unaffected by I.R.C. Section 501 (m).

Your assistance will be greatly appreciated.

Sincerely yours,

Russel H. Dunlap

Russel H. Dunlap
Director

RHD:bk

Grace Brethren Home Missions Council

FINLEY. KUMBLE. WAGNER. HEINE.
UNDERBERG. MANLEY. MYERSON & CASEY

Supplemental Sheet
Comments of
Toyota Motor Manufacturing, USA
to the
Committee on Finance
United States Senate
Regarding
Technical Corrections Act of 1987

A. Designated Representatives of Toyota Motor Manufacturing, USA (TMM)

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B. Summary of Comments and Recommendations

1. Description of the Company

a. TMM is a U.S. corporation chartered in Kentucky.

b. Its assets consist primarily of an $800 million automobile manufacturing plant in its final stages of construction in Georgetown, KY.

c. TMM files federal and state income tax returns.

d. It currently employs approximately 2,200 construction workers and over 9,000 construction jobs will have been created by the project. TMM is projected to employ full-time 3,000 Americans and maintain an annual payroll of approximately $85 million.

e. On July 23, 1985, the Board of Directors of the parent Toyota Motor Company (TMC) initially approved the construction of a U.S. manufacturing facility.

f. On December 11, 1985, TMC announced the selection of a Georgetown, KY site and site preparation began later in December 1985.

g. On February 28, 1986, TMC signed a construction contract with its project manager and Kentucky.

h. On March 13, 1986, excavation of the site began.

2. Proposed Revision of the Act

a. The proposed revision to S. 1350 would add the TMM manufacturing facility to the list of projects qualifying for the master plan exception under Section 204(a)(5)(J)(ii) of the Act.

b. Section 204(a)(5) preserves prior law ACRS depreciation for listed projects and such projects are also entitled to a limited investment tax credit under section 211 of the Act.

3. Arguments in Support of Revision

a. The revision recognizes the important tax policy of granting transition relief to assist companies that made significant commercial investments in reliance on the existing tax structure.

b. TMM's pre-Act commitment to the Kentucky plant is indistinguishable from the other projects of competing domestic and foreign manufacturers that received such treatment in the Act.

c. The provision was included in the Senate bill last year, but was dropped in Conference for reasons unrelated to its merits.

d. Without this revision, U.S. tax policy will be viewed as discriminatory since more favorable tax laws would be applied only to domestically-owned companies, or to joint ventures involving domestically-owned companies. TMC will be penalized for its decision to bring production operations to the U.S., to create a significant number of U.S. jobs and to voluntarily subject itself to U.S. tax authority. Future similar actions by Toyota and others will be frustrated.

Comments of
Toyota Motor Manufacturing, USA

Toyota Motor Manufacturing, USA, Inc. (TMM) wishes to thank the Committee on Finance for the invitation to comment on S. 1350, the Technical Corrections Act of 1987. TMM takes this opportunity to respectfully request that the attached draft legislative language be included in some form in S. 1350. This language clarifies that the TMM automobile manufacturing facility would be entitled to transitional relief similar to that already afforded to other automobile manufacturing plants. This statement is submitted on behalf of TMM by its Washington, D.C. legislative counsel who include Price Waterhouse and Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey.

A. Description of the Company

TMM is a U.S. corporation chartered under the laws of the Commonwealth of Kentucky. Its assets consist primarily of an automobile manufacturing plant currently in the final stages of construction which is estimated to cost approximately $800 million. The plant is located 20 miles north of Lexington, Kentucky in Scott County near Georgetown, Kentucky. The Company files federal and state income tax returns and currently employs approximately 2,200 workers in the construction of the plant and over 9,000 construction jobs will have been created by the project. When completed later this year, the plant is projected to employ approximately 3,000 Americans on a full-time basis and maintain an annual payroll of approximately $85 million. TMM will create an estimated 35,000 jobs itself and through spinoff industries. The Company expects to produce 200,000 Camry 4-door sedans annually by the early 1990's.

A recent study conducted by the University of Kentucky estimated that the plant will generate approximately $632 million in state income, sales and payroll taxes over the next 20 years from TMM, its suppliers and others drawn to Kentucky by the plant. Substantial additional revenues that, in all likelihood, will exceed that amount will also be generated in federal individual and corporate income taxes.

On July 23, 1985, the Board of Directors of the parent Toyota Motor Company (TMC) initially approved the construction of an automobile manufacturing facility to be located in the U.S. On December 11, 1985, TMC announced that Georgetown, Kentucky would be the site of the production facility. Site preparation began in December 1985. On February 28, 1986, a contract was signed between TMC, its project manager and Kentucky in which the Commonwealth agreed, pursuant to the proposal, to provide plant site and project improvements in exchange for Toyota's promise to locate the plant in Kentucky, with title to the project site, as improved, to be conveyed to TMM upon completion of the project improvements. Excavation of the site began on March 13, 1986.

B. Proposed Revision to the Act

The proposed revision to the Technical Corrections Act would add new subclause (III) to section 204(a)(5)(J)(ii) of the Tax Reform Act of 1986 (the Act). This subclause would include the TMM Kentucky facility as one of the projects described under section 204(a)(5) of the Act. Section 204(a)(5) of the Act provides generally that the changes in the accelerated cost recovery rules (ACRS) made by the Act do not apply to any project described by and under section 204(a)(5). Furthermore, section 211 of the Act provides generally that projects exempt from the new ACRS rules (whether by section 204(a)(5) or some other provision) are entitled to a limited investment tax credit.

If the TMM transition rule ultimately is included in the Act, section 204 and 211 would operate together to permit TMM to use investment tax credit and ACRS depreciation rules similar to those in effect when construction began on the plant. The proposed transition rule would not provide TMM with a full investment credit. Rather, the credit that otherwise would have been allowed under the pre-Act rules is subject to a 35 percent reduction. Furthermore, section 211 would require TMM to reduce its basis in the qualifying property by 100 percent of the credit claimed, instead of the 50 percent reduction provided under prior law.

C. Arguments in Support of Revision

Transition rules are provided in the tax law to assist companies that make significant commercial investments in reliance on the existing tax structure. Last year, Congress recognized this policy by granting transition rules to a number of TMM's competitors operating in the U.S., both domestic and foreign. TMM's pre-Act commitment to the Kentucky plant is indistinguishable from the other integrated projects described under section 204(a)(5)(J). A written plan for the construction of the facility was approved on July 23, 1985 -- well before the House version of the Act crystallized. This fact was recognized in the Senate version of the Act which included a transition rule for TMM. Moreover, it should be noted that TMM is in the final stages of plant construction and is further along in the process than the other projects afforded transitional relief in H.R. 2636.

Toyota has pursued a responsible course in international trade by operating within the U.S., by creating a significant number of U.S. jobs, and by subjecting these operations to U.S. taxing authority. In doing so, it relied on existing U.S. tax laws. U.S. tax policy will undoubtedly be viewed as discriminatory if more favorable tax laws are applied only to domestically-owned auto manufacturers, or joint ventures involving domestically-owned companies, and not to TMM, when TMM is in the same or a more favorable position than other manufacturers. Given the substantial economic commitment that the TMM project represents, it is respectfully requested that the Committee on Finance consider the merits associated with the TMM rule and include some form of the attached provision in H.R. 2636.

Section 204 of the Tax Reform Act of 1986, P.L. 99-514, is amended to read as follows: (suggested changes are underlined)

SEC. 204. ADDITIONAL TRANSITIONAL RULES

(a) Other Transitional Rules. --

(5) SPECIAL RULES FOR PROPERTY INCLUDED IN MASTER PLANS OF INTEGRATED PROJECTS. - The amendments made by section 201 shall not apply to any property placed in service pursuant to a master plan which is clearly identifiable as of March 1, 1986, for any project described in any of the following subparagraphs of this paragraph: . . .

(J) A project is described in this subparagraph if -

(i) the project involves an automobile manufacturing facility (including equipment and incidental appurtenances) to be located in the United States, and

(ii) either -- . . . -- <u>or</u>

(III) <u>the Board of Directors of an automobile manufacturer approved a written plan for construction of the project on July 23, 1985, the automobile manufacturing facility (including equipment and appurtenances) will involve a total estimated cost of approximately $790,000,000, and a construction contract was signed on March 14, 1986</u>.

The First Church of Christ, Scientist in Boston, Massachusetts

Office of the Treasurer

July 1, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Re: Section 501(m) of the Internal Revenue Code

Dear Ms. Wilcox:

The purpose of this letter is to request that the Senate Finance Committee consider clarifying the status of Gift Annuity Programs of tax-exempt organizations under §501(m) of the Internal Revenue Code added by §1012 of the Tax Reform Act of 1986. Presumably, such clarification would have to be included in an amendment to the Technical Corrections Act.

Apparently, the intent of Congress in adopting §501(m) was to tax only the commercial-type insurance activities of tax-exempt organizations, including the issuance of annuity contracts. Some commentators indicate that the law is broad enough to cover the issuance of Gift Annuities by such organizations. We question whether that was Congress' intent in view of the nature of Gift Annuities.

As you may know, various tax-exempt organizations administer Gift Annuity Arrangements as a part of their Planned Giving Program. This Church has such an Arrangement whereby a donor transfers cash or securities to the Church and in return receives a lifetime annuity guaranteed by the assets of the Church. It is called a "Gift" Annuity because the rates are designed so as to provide that 50% of the principal transferred to the Church ultimates in a gift to the Church.

This Church does not consider that it is engaged in commercial-type insurance whatsoever but instead feels that it is using a valuable planned giving tool. In fact, in our literature to potential donors, we state that "Since you are making a gift to the Church as well as funding an annuity, the amount of the annuity is not as large as that paid by commercial insurance companies."

THE FIRST CHURCH OF CHRIST, SCIENTIST, CHRISTIAN SCIENCE CENTER, BOSTON, MA. U.S.A. 02115, TELEPHONE (617) 450-2000

We believe that it is important to note that the motivation of the donor is to make a gift, not to obtain an annuity. If the latter reason were predominant, the donor could obtain a much larger annuity from a commercial insurance company.

We understand that gift annuities have been used by charitable organizations for over 100 years. This Church, however, began its Gift Annuity Arrangements in 1972 and has found it a simple method of obtaining contributions, readily understandable by donors and easily administered by the Church. If Gift Annuities were to be held subject to the provisions of §501(m), it would seriously impair our planned giving function as it would add a new complexity to that Program.

If the Church were to eliminate Gift Annuities because of the new administrative burdens imposed by §501(m), the less affluent donor would be restricted in his or her ability to make contributions. The more affluent donors can make use of charitable remainder Unitrusts, Annuity Trusts or Pooled Income Fund Trusts. Because of the intricacies of administering the foregoing types of Arrangements, we have had to place a fairly substantial minimum funding amount on them and, thus, they are not available for the less affluent. The Gift Annuity Arrangement is designed for the non-wealthy donor. It is an anomaly that the Annuity Trust under §664(d)(1), which is somewhat similar to the Gift Annuity, is not affected at all by §501(m) but that the latter arrangement might be.

We sincerely request that the Committee take appropriate action to amend the Technical Corrections Act to provide that Gift Annuity Arrangements are excluded from the scope of §501(m).

Yours truly,

Arthur D. Pinkham

Arthur D. Pinkham, Jr.
Assistant Treasurer

COMMENTS OF FMR CORPORATION RELATING TO PROPOSED TECHNICAL CORRECTION TO THE "SHORT-SHORT" RULE OF CODE SECTION 851(b)(3)

Summary

These comments describe the need for, as well as the basic elements of, a proposed technical correction that would modify the "short-short" rule of Code section 851(b)(3) in cases where regulated investment companies experience significant net redemptions. In such cases, fund managers are required to convert securities to cash and risk violation of the short-short rule. The proposed technical correction would alleviate this problem by allowing a limited amount of gains from the sale or other disposition of securities held for less than three months to be disregarded for purposes of the short-short rule in circumstances where regulated investment companies experience substantial net redemptions.

Background

Section 851(b)(3) of the Internal Revenue Code ("Code") provides that, in order to qualify for pass-through treatment, a regulated investment company ("RIC") must derive less than 30 per cent of its gross income from the sale or other disposition of stock or securities held for less than three months. This requirement is commonly called the "short-short" rule.

Section 654 of the Tax Reform Act of 1986 ("1986 Act") requires a series mutual fund, composed of several portfolios, to treat each portfolio as a separate RIC for all tax purposes (including application of the short-short rule). Before the 1986 Act, some series funds applied the short-short rule on a fund basis while others applied the rule to each portfolio. In resolving this disparity of treatment, Congress did not address the relationship between a short-short rule based on each portfolio and the level of redemptions experienced by each portfolio.

The Conference Report to the 1986 Act indicates that the conferees retained the short-short rule as an "appropriate requirement" to ensure that RICs are "passive" entities. H.R. Rep. 99-841 at II-245. While the legislative history at the time of the inception of the short-short rule in 1936 sheds no light on its purpose, the Internal Revenue Service has viewed the rule as intended to prevent RIC managers from engaging in excessive short-term trading to the detriment of RIC shareholders. See, e.g., Revenue Ruling 75-376. This rationale simply does not apply to net redemption situations where a RIC manager must convert securities to cash in response to the investment decisions of some RIC shareholders over which the RIC manager has no control.

Problem

An individual portfolio can experience significant daily changes in the level of redemption requests, including redemptions resulting from exchanges between two portfolios in the same mutual fund. In order to satisfy substantial net redemptions--where more shares of a portfolio are redeemed than purchased by investors--a portfolio manager must convert substantial amounts of securities held by the portfolio into cash. Unless the short-short rule is amended, portfolio managers will be forced to base these investment decisions on tax considerations to the detriment of portfolio shareholders.

In order to cope with net redemptions and comply with the short-short rule, portfolio managers will be forced to sell long-term securities, hold short-term securities, or take other actions that may be contrary to their best investment judgment. If periods of heavy net purchases are followed immediately by period of heavy net redemptions, a portfolio manager can even be forced to sell short-term securities and jeopardize the qualification of the portfolio for pass-through tax treatment. For example, one actual portfolio in 1986 had net assets of $9 million on May 20, $40 million on July 8, and $16 million on July 18. In order to pay shareholders redeeming between July 8 and July 19, the portfolio had to sell a large block of securities held for less than three months.

The short-short rule has always impeded RIC managers from responding to market conditions and the results of investment analysis in coping with net redemptions. By putting the short-short rule on a portfolio by portfolio basis, Congress exacerbated the problem posed by this rule in two important ways for RIC managers previously operating on a fund basis in coping with net redemptions.

First, a portfolio in a series mutual fund is obviously much smaller than the fund itself. A small RIC is more vulnerable than a large RIC to net redemption pressures because in a small RIC a dramatic increase in net redemptions can be caused by the withdrawal of only a few large shareholders on the same day. For example, in a portfolio with only $50 million in assets, a portfolio manager can be faced with a potential crisis if two shareholders each redeem $1 million on the same day, although the series fund as a whole may have $500 million in assets.

Second, with a short-short rule based on each portfolio, the RIC manager can become vulnerable to net redemption pressures caused by exchanges between two portfolios in the same mutual fund. Such an exchange is accomplished by a redemption of shares in one portfolio and a simultaneous purchase in another portfolio. As a result, a manager of a portfolio with $50 million in assets can be faced with a potential crisis if two shareholders each merely transfer $1 million from this portfolio to another portfolio in the same series fund, although the total assets of such fund remain exactly the same.

In light of the above, Section 851(b)(3) should be amended to provide relief from application of the short-short rule in the case of certain gains attributable to net redemptions. By correcting this problematic effect of the 1986 Act, Congress would help small and start-up RICs, as well as series mutual funds, to comply with the short-short rule. Congress would also be adjusting the short-short rule to allow investors to enjoy a wider range of choice through exchanges between portfolios.

Explanation

The proposed technical amendment would add a new subsection (h) to Code section 851. The amendment is modeled after subsection (g), added by the 1986 Act, concerning designated hedges. Thus, any gain which comes within the scope of subsection (h) would be excluded from both the numerator and the denominator of the fraction called for by section 851(b)(3).

The amendment provides that certain gains derived during a specified period are disregarded for purposes of Section 851(b)(3). The period begins on the day after a RIC experiences daily net redemptions in excess of 1% of its net asset value and ends when net investments in the RIC are sufficient to counterbalance the net redemptions experienced on the trigger date. The gains disregarded for purposes of section 851(b)(3) would be limited by the amount of sales proceeds needed to satisfy the net redemptions. Other elements of this proposed amendment have been considered in discussions between staff and representatives of FMR Corporation.

In sum, the proposed technical correction would enable a fund manager to respond to significant net redemptions without jeopardizing the status of the RIC.

FOUNDATION FOR THE CAROLINAS

July 6, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I am writing to comment in protest against the proposed technical change to the tax law of 1987 which would repeal the charitable deduction as an offset against the generation skipping tax on charitable lead trusts created after June 10, 1987.

The proposed repeal of the GSTT is a substantive and not technical change that would have a serious negative effect on a number of charitable organizations. It is clearly wrong to permit substantive changes to the tax act of 1986 under the guise of technical corrections.

The tax law enacted by Congress last year with its elimination of the charitable deduction for non-itemizers and the inclusion of charitable gifts in the calculation of the alternative minimum tax was destructive to the efforts of charitable organizations. At a time when the Federal government is continuing to shift funding responsibilities back to the states and local communities, there is an increasing pressure on not for profit organizations to help fill a large void in support to health and human services, education and the arts.

The Senate Finance Committee is urged to remember that value and to not support approval of this proposed "technical correction."

Sincerely,

William L Spencer

William L. Spencer

WLS/if

301 South Brevard Street Charlotte, North Carolina 28202 (704) 376-9541

FRIEDMAN
ALPREN &
GREEN
CERTIFIED PUBLIC ACCOUNTANTS

1700 BROADWAY
NEW YORK, NY 10019
212-582-1600

July 15, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Dear Ms. Wilcox:

We are a regional firm of Certified Public Accountants and have a substantial number of clients in the real estate industry. Our comments in this letter relate to several of our clients who we believe have been unfairly treated under the "passive loss" provisions of the Tax Reform Act of 1986 (TRA-1986). We are writing to you to gain your support for relief through technical corrections or through other appropriate alternatives.

The intent of Congress in introducing the passive loss rules (Sec. 469 IRC) was clearly stated in the Senate Finance Committee Report on H.R. 3838 (Pages 713-718). In summary, these rules were adopted to significantly limit the use of tax shelters to restore faith in the Federal income tax system, and to change the perception of average citizens that they are bearing a disproportionate burden of the costs of government because of the tax shelters of the wealthy.

The Senate intended to solve the problem by preventing outside investors from avoiding tax liability on salary and portfolio income by investing in tax shelters. In addition, they attempted to achieve fairness by allowing those active in businesses (except rentals) to which tax preferences are directed to utilize those benefits even though they may shelter unrelated income. However, with respect to several of our clients, the passive loss rules have not been successful in achieving Congress' goals because the rules prevent our clients from even being able to apply tax losses from rental activities against income derived from non-rental activities related to the real estate business. Thus, the passive loss rules single out rental real estate for harsher treatment than other businesses because those active in other businesses can apply losses realized in those businesses against all other categories of income.

The "passive loss rules" operate by not allowing the deduction for the excess of losses from passive activities over income from such activities. The term "passive activities" includes any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate. Rental activities are arbitrarily treated as passive activities whether or not the taxpayer materially participates.

Under the rules, portfolio income (which among other things includes interest income) is specifically not treated as income from a passive activity. However, interest income will not qualify as portfolio income where it is derived in the ordinary course of a trade or business and it will not qualify as passive income if the material participation standard is met.

Our clients own directly a substantial amount of rental real estate. Their activities consist of developing real estate and/or buying, holding and managing commercial and residential rental properties and selling the properties when it is appropriate to do so. They generally hold the rental properties for a substantial period of time before they sell them. When a property is sold, they have often taken back a purchase money note of the purchaser while electing the installment method to report the gain on sale. To summarize, our clients are real estate professionals engaged full-time in the real estate business, (i.e., developing, buying, managing and selling), and it was not intended by Congress to have their tax benefits curtailed as a result of tax reform efforts.

As a result of the enactment of the passive loss rules, we have projected that our clients will have non-deductible passive losses arising from rental activities and, concurrently, will have to recognize development, management and portfolio income (arising from interest on the purchase money mortgages). While it is true that the passive loss limitation merely defers the losses from a passive activity until all assets involved in the activity are sold, our clients will not sell all of their rental properties to recoup the losses because this is the business from which they earn their livelihood and they are not ready to retire. The tax laws should not be designed to encourage one to abandon his occupation.

Since the real estate business has been singled out for arbitrary treatment where rental activities are present, we suggest that other activities connected with the real estate business (including interest on purchase money mortgages) should necessarily be accorded passive treatment as well. Assuming this change is made, our clients would still be unable to offset net losses from the real estate business against non real estate related income, something which professionals in other fields can do.

We are not asking for a result that is unsupported by the expressed intent of the Senate in passing this legislation. This change would give to our clients the tax benefits which relate to the trade or business that they are in. Even though the passive loss rules arbitrarily separate their business into rental and other activities, the Tax Code should not operate in such a manner so as to deny a real estate professional the opportunity to offset deductions or losses incurred in his trade or business against all sources of income included in that same business. It would be wrong for us to have to suggest to taxpayers that they have to sell all of their rental properties to use their deductions or that they sell their mortgages and invest in a vechicle which generates passive income.

We trust that the foregoing information will enable you to develop a remedy for this unfortunate and unfair situation. We deeply appreciate your interest and your assistance.

Very truly yours,

Robert Kaplan

RK:lk

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD

William J. Wilkins, Esq.
Chief Counsel
219 Dirksen Building
United States Senate
Committee on Finance
Washington, D.C. 20510

RE: Submission for the Record on S. 1350 the Technical Corrections Act of 1987

Dear Bill:

On behalf of the General Electric Pension Trust, I am submitting the following comment on S. 1350, the Technical Corrections Act of 1987. The comment, as more fully described below, concerns the definition of "rents from real property" for purposes of the unrelated business income tax (UBIT) and for qualifying as a real estate investment trust (REIT).

Background

The Tax Reform Act of 1986 (Pub. L. No. 99-514)(the "Act") contained a provision that treats rents based on the net income of the tenant as "rents from real property" for purposes of meeting the REIT income requirements, provided that the tenant's profits are derived only from sources that the REIT would be permitted to earn directly (section 663(b) of the Act; Code section 856(d)(2) and (6)). Under prior law, such rents were not "rents from real property" for purposes of qualifying as a REIT. The purpose of the prior law limitation was to ensure that a REIT was a wholly passive investor in real property, and not an active business competitor with businesses that do not receive such conduit treatment (S. Rep. No. 1357, 93rd Cong., 2d Sess., reprinted at 1975-1 C.B. 517, 524 and H.R. Rep. No. 2020, 86th Cong., 2d Sess., reprinted at 1960-2 C.B. 819, 823).

Exempt organizations, such as pension trusts, face the same limitation on rents based upon the profits of the tenant as REITs previously did for similar reasons. Rents from real property are exempt from unrelated business income tax generally (Code section 512(b)(3)). However, if the rents are based upon the income or profits derived by any person from the leased property, the exemption does not apply (Code section 512(b)(3)(B)(ii)). Exempt organizations receiving rents based upon the tenant's profits are viewed as assuming the risks inherent in the particular business of the tenant, and thus as becoming engaged in a business generally unrelated to their exempt purpose. If, however, the income from the underlying business would be treated as exempt if received by the exempt organization directly, there is no reason to impose the UBIT simply because the income is received through an intermediary.

This is in fact the rationale for the change made to the REIT definition of "rents from real property" by the

Act. The Senate Finance Committee report concluded that a REIT receiving rental income where the prime tenant's rent from the property depends only on rents received from the property is not participating in the profits of any active business other than that pertaining to the rental of its own property, even though the prime tenant's rent is based upon its net profits (S. Rep. No. 313, 99th Cong., 2d Sess. 776 (1986)).

Proposed Technical Correction

Pension trusts and other exempt organizations may also receive passive income through a prime tenant whose rent is based on its net profits from rents derived from subtenants. Since their inception, the UBIT rules exempting rents from real property that were not based on the income or profits of the tenant from tax have been linked to their REIT counterpart. When Congress enacted Code section 512(b)(3)(B)(ii) in the Tax Reform Act of 1969 (Pub. L. No. 91-172), it intended to maintain the distinction between passive and active business income, and purposely incorporated the test for "passive" rentals used for REITS into the UBIT rules (S. Rep. No. 552, 91st Cong., 1st Sess. 68-69 (1969)). Consistent with the Committee Report, the Treasury regulation implementing this part of the statute, Treas. Reg. Sec. 1.512(b)-1(c)(2)(iii)(b), references the rules contained in the regulations governing REITs, Treas. Reg. Sec. 1.856-4(b)(3) and (6). By failing to conform the definition of rents from real property for UBIT purposes, the Act has upset the long-established congruity between these two provisions.

Conformity could be reestablished by amending Code section 512(b)(3)(B)(ii) by inserting after the parenthetical ", except as provided in subparagraph (C)", by redesignating subparagraph (C) as subparagraph (D), and by adding the following new subparagraph (C):

> "(C) Clause (ii) of subparagraph (B) shall not operate to prevent the application of subparagraph (A) to amounts received by an organization if--
>
> > (i) an organization receives or accrues, with respect to real or personal property, amounts from a tenant which derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and
> >
> > (ii) such tenant receives or accrues, directly or indirectly, from subtenants only amounts which would be treated as rents excludable under this paragraph if received by the organization."

I appreciate the opportunity to comment upon this issue and the technical corrections legislation.

Sincerely,

Jayne

Jayne F. Boyle

June Gibson

1106 Monte Largo, NE
Albuquerque, New Mexico 87123
(505) 298-1653

September 27, 1987

The Senate Finance Committee
Laura Wilcox, Hearing Clerk
SDOB 205
Washington, D. C. 20510

Dear Ms. Wilcox:

Concerning Technical Corrections Bill S1350 soon to be considered by the Senate Finance Committee, I request that you add my concerns to the official comments on this matter.

The Tax Reform Act of 1986 requires freelance writers to capitalize deductions over the earning life of the work for which the expenses were incurred, just as manufacturers deduct expenses for assembling products. Unlike manufacturers, however, writers will not be permitted to take deductions for research and development of our products (ideas). The nature of the publishing business is such that only a few big-name authors can hope to presell their ideas. The rest of us must research and develop a marketable piece of work before approaching a publisher, with no assurances that our efforts will be rewarded. Even if we have a contract or assignment, estimating income from a book that may be on sale for 6 weeks or 16 years, or from an article that may run once or be reprinted several times, will be, to put it mildly, an accounting nightmare.

The requirement that self-employed individuals show a profit for 3 out of 5 years should prevent the unscrupulous or never-successful writer from taking inappropriate deductions. The capitalization rule, however, will prevent countless free-lancers from ever becoming profitable (taxable), and it will most certainly discourage budding talent, which can only develop with time and a social environment conducive to creativity.

A clarification of the Technical Corrections Bill S1350 is needed. Specifically, this clarification should indicate that freelance writers' expenses in researching and writing literary products are not subject to capitalization rules.

June Gibson

June Gibson

Summary of Comments on the Technical Corrections Act of 1987

T. Byron Collins, S.J.

Samuel Harvey, Jr.

Assistants to the President
Office of Federal Relations
Third Floor Healy
Georgetown University
Washington, D.C. 20057
625-3704

Summary of comments on The Technical Corrections Act of 1987, S. 1350, relating to the Tax Reform Act of 1986 and provisions within it allowing for the issuance of Tax Exempt Bonds on behalf of a university founded in 1789.

The present Tax Reform Act of 1986 has a provision allowing the particular university to issue tax exempt bonds in the amount of 200 million dollars for projects completed or underway through the jurisdiction in which the university resides, and with bonds approved by that jurisdiction. This authority was signed into law. Prior to the signing into law, the particular university notified the House Ways and Means Committee and the Senate Finance Committee of the inability to proceed because of an unrelated court case affecting the governmental authority and the university .

A modification was made to the transition rule allowing the university to seek relief in adjacent jurisdictions. Since that time, the University has petitioned the two adjacent jurisdictions to get appropriate steps accomplished. Both jurisdictions were unable to accommodate the request.

The intent of the Congress included consideration of the cost of the 200 million in tax exempt bonds in permitting the transition rule. It is necessary to permit the University to issue tax exempt bonds itself. There is a similar provision for certain universities in the present transition rule.

Comments on the Technical Corrections Act of 1987

Comments on S-1350 The Technical Corrections Act of 1987 relating to the Tax Reform Act of 1986 and provisions within it allowing for the issuance of Tax Exempt Bonds on behalf of a university founded in 1789.

Present text-page 414 (lines 9-25) page 415 (lines 1-3)

(33) Subparagraph (H) of section 1317(33) of the reform act is amended--

(A) by striking out clause (ii) and inserting in lieu thereof the following:

"(ii) the proceeds of the issue are to be used to finance projects (to be determined by such university and the issuer) which are similar to those projects intended to be financed by bonds that were the subject of a request transmitted to Congress on November 7, 1985, and", and

(B) by adding at the end thereof the following new sentence: "Bonds to which this subparagraph applies shall be treated as qualified 501(c)(3) bonds if such bonds would not (if issued on August 15, 1986) be industrial development bonds (as defined in section 103(b)(2) of the 1954 Code), and section 147(f) of the 1986 code shall not apply to the issue of which such bonds are a part."

For the purpose of clarification, this section (33) should be changed to read as follows:

(33)

(a) Subparagraph (H) of section 1317(33) of Public Law 99-514 is amended by striking out clauses (i) and (ii) and inserting in lieu thereof the following:

"(i) the issue is issued by a university founded in 1789 and incorporated under the laws of the United States in 1815 (or for the benefit of such a university by a state or local government),

"(ii) the proceeds of such an issue are to be used to finance projects which are similar to those projects intended to be financed by bonds which were the subject of a request transmitted to Congress on November 7, 1985,

"(iii) no bond issued as part of such issue would have been an industrial development bond (as defined in section 103(b)(2) of the 1954 Code) if issued before August 16, 1986, and

"(iv) such an issue meets the requirement of section 145(a)(1) of the 1986 Code."

(b) Subparagraph (H) of section 1317(33) of Public Law 99-514 is amended by adding at the end thereof the following: "Bonds issued as part of an issue to which this subparagraph applies shall be treated for purpose of the 1986 Code as qualified 501(c)(3) bonds (as defined in section 145 of such Code) issued by a State and section 147(f) of Code shall not apply to such bonds."

(The above language was prepared by a joint committee staff member at the direction of the Chairman of the Ways and Means Committee.)

Explanation

The present language permits a certain university to issue tax exempt bonds in the amount of 200 million dollars either through the jurisdiction in which it is located or through a jurisdiction outside its location.

Because of an unrelated court case, this university and the jurisdiction in which it is located are prevented from the issuance of the bonds. The court case does not appear to be resolvable in the foreseeable future.

The University has found that the two appropriate neighboring jurisdictions , that the present language would allow, will not issue the tax exempt bonds.

The above information has been presented in detail to the Chairman and Ranking member of the Ways and Means Committee.

For this reason the clarification language was proposed to the Senate Finance Committee Chairman in the first meeting by the Chairman of the the Ways and Means Committee.

In addition a petition was made by a Senator, who is a member of the Senate Finance Committee, in a May 22, 1987, letter to the Chairman of the Senate Finance Committee:

"For several years, a "University founded in 1789" has attempted to have tax exempt bonds issued on its behalf through the District of Columbia. The issuance of these bonds have been held up indefinitely by an unrelated suit before the D.C. Court of Appeals.

Because this university had made plans based on prior law, Congress included a transition rule in the Tax Reform Act of 1986, allowing the university to rely on prior law with respect to the treatment of the tax exempt bonds. Although this rule was included in the tax reform bill, a clarification was provided in the concurrent resolution accompanying the tax bill to permit the university greater latitude in having the bonds issued. Unfortunately, a further modification of the transitional rule is now necessary because, in spite of Congressional intent to the contrary, it appears that this university will be indefinitely foreclosed from having bonds issued on their behalf.

I believe this is a reasonable request and consistent with the ground rules you have established for the Technical Corrections legislation. Congress intended in the tax reform bill to permit up to $200 million of the bonds to be issued for this university. The cost of these bonds was calculated in the revenue estimates of the bill and the requested a modification would only serve to enable this university to do what Congress had originally proposed. It is necessary that the technical amendment permit the university to serve as the issuer of the bonds. While I realize this is unusual, I understand it to be consistent with other transition rules in the Tax Reform Act which permit certain state-related, private universities to issue tax exempt bonds."

The response of the Chairman of the Senate Finance Committee to the Senator on May 28, 1987, states:

"I understand that "the particular university" has been unable to issue tax exempt bonds under the transition rule because of a legal dispute in the District of Columbia. It is unfortunate that a six year old court case is delaying the issuance of "the particular university's" bonds.

The issue of this "particular university" has been seriously discussed on a number of occasions in the preparation of that bill. Unfortunately, under the very strict definition of technical correction which we have utilized in sifting through the myriad of requests, it does not appear that the change requested by "this university" will qualify. Nevertheless, this is certainly an issue that can be discussed in the Finance Committee when we meet to consider technical corrections."

In a letter of June 18, 1987, a Republican Senator of the Senate Finance Committee made a similar petition to the Ranking Member:

For several years, a particular university attempted to have tax exempt bonds issued on its behalf through the District of Columbia. The issuance of these bonds have been held up indefinitely by an unrelated suit before the D.C. Court of Appeals.

You may recall that last year in recognition of the unique problems facing this university transition relief was provided to permit up to $200 million of bonds to be issued. An interested Senator's amendment which would provide issuing authority to the university is necessary to allow this university to proceed.

I hope we will be able to resolve this problem during committee consideration."

<u>In Summary:</u>

The present Tax Reform Act of 1986 has a provision allowing the particular university to issue tax exempt bonds in the amount of 200 million dollars for projects completed or underway through the jurisdiction in which the university resides, and with bonds approved by that jurisdiction. This authority was signed into law. Prior to the signing into law, the particular university notified the House Ways and Means Committee and the Senate Finance Committee of the inability to proceed because of an unrelated court case affecting the governmental authority and the university .

A modification was made to the transition rule allowing the university to seek relief in adjacent jurisdictions. Since that time, the University has petitioned the two adjacent jurisdictions to get appropriate steps accomplished. Both jurisdictions were unable to accommodate the request.

The intent of the Congress included consideration of the cost of the 200 million in tax exempt bonds in permitting the transition rule. It is necessary to permit the University to issue tax exempt bonds itself. There is a similar provision for certain universities in the present transition rule.

In accordance with instructions in Press Release #G-3, Wed. June 17, 1987, the comments are within the ten page limit, and a one-page summary is also included.

Submitted by:

T. Byron Collins, S.J.

Samuel Harvey, Jr.

Assistants to the President
Georgetown University
Washington, D.C.

May 6, 1987

The Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

As Director of Planned Giving at Gordon College, a liberal arts college with a student body of 1,200, I feel deep concern over the potential taxation of charitable gift annuities.

Gordon College has a small endowment. Approximately six years ago the Planned Giving Department was established for the purpose of building endowment. The Charitable Gift Annuity has been one of the most effective programs in achieving our goal. In most cases our supporters are financially limited to the extent they can make outright gifts. They are desirbous of making gifts to Gordon College and the guaranteed life income from a gift annuity enables them to satisfy their donative intent.

Gordon College will appreciate your leadership in clarifying that I.R.C. Section 501 (m) does not apply to gift annuities from taxation and preserving this plan which has been in use for over 100 years will be of unestimable service to the charitable community.

Yours truly,

Miriam F. Kenyon (Mrs.)
Director
Department of Planned Giving

MFK:sl

Summary Statement on S. 1350
Government Finance Officers Association

The Government Finance Officers Association (GFOA) provides comments on six technical issues in its written statement. The Association which represents state and local government finance experts, takes the position that:

1. The Committee should oppose any recommendation to overturn the recent City of Tucson, Arizona v. Commissioner of Internal Revenue decision in the proposed Technical Corrections Act of 1987. The decision, invalidating the Treasury Department's sinking fund regulations on tax-exempt bonds, reverses rules which GFOA feels were overbroad and failed to take into account traditional state and local practices of sound fiscal management.

2. A provision should be added to the proposed Technical Corrections Act that would ensure that the Treasury Department regulations governing the State and Local Government Series Securities (SLGs) fulfill Congressional intent by making the program flexible and providing an alternative to the arbitrage rebate requirement.

3. A provision giving an exemption to state and local governments from the mandatory distribution rule should be added to the Technical Corrections Bill to prohibit "double-dipping"and permit states and localities to comply with federal legislation prohibiting mandatory retirement.

4. Language should be added to the Technical Corrections Bill clarifying that Section 457 of the Internal Revenue Code relating to deferred compensation plans applies only to elective compensation and not to nonelective plans. If nonelective plans are covered, state and local employees would be required to pay current income taxes on such benefits as accrued vacation and sick pay.

5. Language clarifying that footnotes 160 and 173 in the Joint Tax Committee's "Blue Book" do not reflect Congressional intent should be added to the Technical Corrections bill. This clarification would prevent excess tax receipts of state and local governments from being subject to the arbitrage rebate requirement and pension funds, insurance reserve funds and other legally restricted funds of states and localities would not have to be used to finance operating needs.

6. Small governments should be given relief from the new tax-exempt debt information reporting requirement to correct an inconsistency in the treatment of small issuers and reduce reporting compliance costs. GFOA supports insertion of a technical change permitting issuers of not more than $10 million in tax-exempt financing per annum to fulfill the reporting requirement by certifying to the IRS they will not exceed the $10 million limit.

Designated representative: Cathy Spain/Cathie Eitelberg
Government Finance Officers Association
1750 K Street, NW, Suite 200
Washington, DC 20006
(202) 429-2750

Comments of the
Government Finance Officers Association (GFOA)
on S. 1350
Technical Corrections Act of 1987*

A professional organization representing 11,000 state and local officials and other finance professionals involved in all the disciplines comprising public finance, the Government Finance Officers Association (GFOA) is pleased to present these comments on the Technical Corrections Act of 1987 for consideration by the Senate Finance Committee. While we disagree in substance with provisions enacted in the Tax Reform Act of 1986 affecting the financing of state and local government facilities, we have limited our comments to technical concerns.

GFOA opposes any attempt to overturn the City of Tucson decision in the Technical Corrections Bill.

A June 12, 1987 decision of the U.S. Court of Appeals for the District of Columbia Circuit, City of Tucson, Arizona v. Commissioner of Internal Revenue, overturned U.S. Treasury Department sinking fund regulations. The rules which provoked a firestorm of criticism by state and local governments when introduced in 1978 were criticized by the Court as being at odds with the underlying statutory precept. Congressional staff members have been quoted in the press recently as supporting a reversal of City of Tucson in the pending Technical Corrections Bill. GFOA strongly urges Congress to resist any recommendation to overturn the invalidated sinking fund regulations as part of the Technical Corrections Bill as it is not a matter for technical correction.

Briefly, Treasury sinking fund regulations define as "bond proceeds" any state or local government tax receipts or other revenues such as revenues from the sale of property or a favorable judicial judgment that are held in a sinking fund (a debt service or other type of fund a state or local government borrower expects to use to pay principal or interest on an issue). By making this designation, the investment of these sinking funds until they are needed to repay bonds outstanding is severely restricted because they are subjected to the arbitrage limits that apply to bond proceeds that have not been spent.

To avoid both imposing undue restrictions on state and local governments and the development of potentially abusive forms of transactions, any changes in this area should only be made after public hearings and careful deliberations including establishment of a consultation process with representatives of state and local governments. It is important for Congress to consider the cause of discontent on the part of state and local governments with the sinking fund regulations as well as the excessive breadth of the regulations which the Court reversed. GFOA realizes there may be matters of valid concern to which the proposed regulations relate. Nevertheless our membership has taken the position that the regulations imposed by Treasury were overbroad and failed to take into account traditional state and local practices of sound fiscal management.

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*Prepared by Catherine L. Spain, Director, Federal Liaison Center, Government Finance Officers Association, 1750 K Street, NW, Suite 200, Washington, DC 20006, (202/429-2750). Questions or additional information concerning the issues presented in these comments should be directed to Ms. Spain or Cathie Eitelberg, Assistant Director of the Federal Liaison Center.

We believe the sinking fund problem is similar to the issue surrounding Footnotes 160 and 173 in the Joint tax Committee "Blue Book" which is discussed below. GFOA has written to Treasury Secretary Baker offering to assemble a panel of state and local officials to advise on forthcoming arbitrage regulations implementing the 1986 Tax Reform Act provisions and Footnotes 160 and 173. We believe this would be an appropriate forum to discuss revisions to the sinking fund regulations.

GFOA supports adding a provision to the Technical Corrections Bill that would fulfill Congressional intent regarding the State and Local Government Series (SLGs) Program.

Section 1301 of Tax Reform Act of 1986 directed the U.S. Treasury to modify the State and Local Government Series (SLGs) program by providing issuers with instruments allowing flexible investment of bond proceeds in order to eliminate the earning of rebatable arbitrage. The Government Finance Officers Association has reviewed these regulations and finds that they fail to meet the intent of Congress to provide a flexible and administratively simple alternative to the arbitrage rebate. We have identified two aspects of the regulations that must be changed in order to rescue the program.

Specifically, GFOA recommends that the prohibition in the proposed regulations that prevents an issuer from mixing investments between the demand-deposit and time-deposit SLGs programs be changed. To remedy this problem we propose that Treasury permit issuers to make a one-time, up-front declaration of a split between the respective percentages of the bond proceeds they desire to be invested in demand-deposit SLGs and time-deposit SLGs. This approach gives the state or local cash manager the flexibility required for project financing without disrupting the U.S. Treasury Department's cash management operations because the total amount of funds available and the cash flows will be reasonably predictable. Further, it can be argued that this approach is even more predictable than the one proposed in the regulations because there will be fewer early redemptions by issuers who have failed to accurately predict their cash requirements. As envisaged, as time-deposit securities matured, they could be rolled over into the demand-deposit program. Additionally, if an issuer's demand-deposit balance was too high, an issuer could invest those proceeds in the time-deposit program, consistent with the notification and other rules of that program.

The formula designed by the Treasury for determining the weekly interest rate on demand-deposit securities results in a rate that is unacceptably low. The viability of the program hinges on issuers' ability to earn an adequate return on their investments. As proposed, issuers will earn a rate that is less than the tax-exempt rate at which they borrowed. Our recommendation is for Treasury to set a rate that is an index of short-term municipal rates and is not further reduced by an administrative fee. The use of such an index would preclude the need to adjust the derived rate by an "average marginal tax rate." We believe such a rate can be constructed easily based upon data reported in the Bond Buyer or other publications and will adequately cover Treasury's administrative costs. We reject the use of the fed funds rate as a base for the formula proposed by Treasury because of its inappropriateness under certain market conditions.

Since the Treasury Department has not yet modified the program to respond to our objections and fulfill Congress' intent we endorse a technical correction to assure that state and local government bond issuers will be able to avoid the overly complex and costly recordkeeping and computational requirements of the arbitrage rebate requirement.

<u>GFOA supports adding a provision to the Technical Corrections Bill to exempt state and local governments from the mandatory distribution rule</u>.

Section 1121 of the Tax Reform Act of 1986 repealed one of two criteria that had been in the federal tax code governing the timing of the distribution of pension benefits to employees. Under prior law, distributions were required to begin on the April 1st of the calendar year following the calendar year in which (1) the employee attained age 70 1/2 <u>or</u> (2) the employee retired, whichever was later. The second criterion has been repealed.

This tax reform provision was intended to preclude highly compensated private sector employees from using a pension plan as an estate planning device rather than for retirement purposes. This practice resulted in the avoidance of or reduction in taxes. However, state and local government systems operate under laws which prevent retirement benefits from being used in this way.

The new distribution requirement creates both policy and administrative burdens for state and local government retirement systems. Moreover, when this tax act change is viewed in light of two 1986 amendments to the Age Discrimination in Employment Act (ADEA), the problem is further complicated. These two provisions prohibit an employer from establishing a mandatory retirement age and from using age as a criterion for stopping retirement plan benefit accruals. We support a technical correction because

- The combined result of the three provisions is that an individual who has reached the mandatory distribution age (approximately age 71) and continues to work would <u>simultaneously</u> (1) collect a salary, (2) collect a retirement benefit, and (3) continue to accrue additional future retirement benefits. This scenario is further complicated as it can continue indefinitely because of the repeal of a mandatory retirement age.

- This federal distribution rule conflicts with state and local laws. Most states and scores of cities and counties prohibit employees from collecting both a retirement benefit and a salary. This practice, which is referred to as "double-dipping," is prohibited on public policy grounds and is similar to federal laws which restrict this practice in its workforce.

- Noncompliance with the federal law results in an extremely harsh penalty for the participant and jeopardizes the plan's tax-exempt status. A 50 percent nondeductible excise tax is levied on the amount which should have been distributed and is to be paid by the employee.

The Technical Corrections Bill should exempt state and local government workers from this provision because it disrupts sound state and local policy, creates extraordinary cost and administrative burdens on pension plans and undermines the intent of the repeal of a mandatory retirement age by making workers choose between giving up their job or paying tax on monies never received.

<u>GFOA supports the inclusion of language in the Technical Corrections Bill clarifying that Section 457 of the Internal Revenue Code does not extend to nonelective deferred compensation</u>.

Section 1107 of the Tax Reform Act of 1986 extended Internal Revenue Code Section 457 rules limiting elective deferred compensation plans to certain tax-exempt organizations. Section 457 as enacted in 1978 formerly applied only to the deferral of compensation by employees of state and local governments.

Since the passage of the Tax Reform Act, the Internal Revenue Service has taken the position in Notice 87-13 that the types and nature of deferred compensation plans governed by Section 457 also includes nonelective deferred benefit plans which generally had been thought to be outside the scope of the Section 457 rules. Examples of nonelective benefits plans could include vacation, sick time, and other benefits. The position adopted by IRS is inconsistent with the statutory language in the Tax Reform Act and the conference report accompanying the Act. No indication is given of Congressional intent to expand the type or nature of plans covered by Section 457. Additionally, the Joint Tax Committee's General Explanation of the Tax Reform Act of 1986 confirms our position that no change was made in the type or nature of deferred compensation plans subject to Section 457 rules. It states that 457 "continues to apply to the same types of deferred compensation to which it applied under prior law." (p.654)

GFOA supports a statement by Congress that Section 457 is not intended to apply to nonelective deferred compensation. If the IRS interpretation prevails state and local government employers would confront administrative nightmares coordinating elective and nonelective deferred benefit plans if both types of deferrals were subject to Section 457 limits. Furthermore the IRS position would result in state and local employees paying income taxes on a current basis for nonelective deferred benefits. This treatment is totally at odds with the history of federal income taxation where individual taxpayers are taxed on a cash-basis rather than an accrual-basis method of accounting.

GFOA supports the inclusion of a provision in the Technical Corrections bill clarifying that Footnotes 160 and 173 in the Joint Tax Committee's "Blue Book" do not reflect Congressional intent.

Two footnotes (numbers 160 and 173) in Joint Tax Committee's General Explanation of the Tax Reform Act of 1986 (the Blue Book) contained unexpected and overly broad interpretations of the new arbitrage provisions. The first provides that excess tax receipts invested in a bond reserve fund are to be rebated to the Treasury. The example given involves a general tax levy to pay debt service on governmental bonds. Because some of the taxes may be paid late, additional (or excess) taxes may have to be assessed to cover possible shortfalls. The footnote directs Treasury to treat those tax receipts not used to pay debt service as a reserve subject to the general arbitrage rebate requirement.

The second footnote instructs Treasury to require governmental units to treat certain funds as being available to an issuer if restrictions on the fund were established by the issuer or the issuer has the power to alter the use of the fund. This means that issuers of short-term tax and revenue anticipation notes would have to factor in funds traditionally unavailable when calculating their expected annual cash-flow deficit. For example, funds set aside for self-insurance reserves may have to be considered available for operating purposes.

GFOA believes that these footnotes are beyond what Congress intended. Further, it supports the addition of language in the

Technical Corrections Bill clearly indicating that (1) excess tax receipts in a debt reserve fund should not be subject to the arbitrage rebate requirement and (2) state and local governments should not be required to consider funds set aside for nonoperating purposes to be available to meet current expenses when sizing their short-term borrowings for cash-flow deficit purposes. Examples are self-insurance and pension funds.

GFOA proposes that Congress correct an inconsistency in its treatment of small issuers by modifying the newly mandated information reporting requirement.

Section 1301 of the Tax Reform Act of 1986 requires issuers of tax-exempt bonds to report each transaction to the Internal Revenue Service. For purposes of the Act the term "bond" also includes leases, loans and short-term note issues. This requirement is especially burdensome for small governments that do not finance their capital equipment by going to the municipal bond market and obtaining the services of bond counsels who will ensure that they comply with the new requirement. Small borrowers often obtain their needed financing from local financial institutions in the form of a loan and without the benefit of a federal tax code expert assisting in the transaction. Failure to report carries a stiff penalty--retroactive taxability of the interest earned on the debt.

We recommend that this reporting cost burden be reduced by permitting small issuers (not more than $10 million in tax-exempt financing per annum) to fulfill the requirement by simply certifying to IRS they have issued no more than $10 million rather than reporting their financings. This treatment is consistent with the Tax Reform Act provision permitting small issuers to sell up to $10 million of tax-exempt bonds annually which are eligible for the bank interest deduction. The bank deduction provision recognizes the needs and limitations of smaller issuers and was included to reduce financing cost burdens.

July 20, 1987

GREAT WESTERN FINANCIAL CORPORATION
GREAT WESTERN SAVINGS

Michael J. Palko
SENIOR VICE PRESIDENT

July 23, 1987

Statement to Senate Finance Subcommittee
on Taxation and Debt Management
Regarding S. 1350, The Technical Corrections Act of 1987

Great Western Financial Corporation wishes to recommend to the Finance Subcommittee that it include in S. 1350 or other tax legislation a correction of the effective tax rate (ETR) increase that will be incurred by most thrift institutions in 1987 as a result of the Tax Reform Act of 1986 (1986 Act).

We believe that it was intended that the 1986 Act should continue the pre-1987 31.28% ETR of thrifts. However, through an oversight, most thrifts will incur an unintended higher ETR for 1987 of as much as 36.8% before returning to 31.28% in 1988. This will cause a serious reduction to the net worth and 1987 earnings of Great Western Financial Corporation and many other thrifts because of the manner in which tax expense is determined for financial accounting purposes. However, we understand that correction of this oversight will produce a relatively negligible revenue loss of only about $20 million.

This effective tax rate (ETR) increase is a particularly critical factor because it will cause most thrifts to incur a direct adverse effect to 1987 earnings and net worth far greater than the tax revenues involved. This ironic effect will occur because generally accepted accounting principles (GAAP) that are unique to the thrift industry require the bad debt deduction to be treated in a manner which directly affects the financial accounting tax provision and the earnings of a thrift. Since, in most cases, the financial accounting income of a thrift is greater than its taxable income, the 1987 ETR increase will produce a reduction to the earnings of thrifts that will be materially greater than the tax revenue produced by the ETR increase. This loss of earnings and net worth will be particularly damaging to the thrift industry as it attempts to ameliorate its long-term financial problems.

Prior to the 1986 Act, thrift institutions had three bad debts reserve methods available to them: experience, percentage of eligible loans, and percentage of taxable income. The experience and percentage of eligible loans methods were the same as those available to commercial banks. The percentage of taxable income method (PTI), unique to thrift institutions, allowed a deduction of up to 32 percent* of taxable income if at least 82 percent of a thrift's assets were qualified. A thrift eligible for the maximum PTI deduction was, therefore, able to reduce its effective tax rate from the general corporate rate of 46% to 31.28%.

The PTI deduction was originally provided when thrift institution activities were severely restricted by state and

*As a preference item, the statutory maximum deduction of 40 percent was effectively reduced to 32%.

federal regulators. The deduction was intended, at least in part, to compensate thrifts for their inability to compete in certain financial markets and also to encourage their primary activity of providing residential mortgage loans.

In reviewing the thrift bad debt reserve methods for purposes of the 1986 Act, it is noted in both Committee reports that both thrift and non-thrift financial institutions are now competing in many of the same markets due to a loosening of prior restrictions on their activities. In recognition of this situation, Congress, while reducing the tax rate of non-thrift financials from 46% to 34%, decided t retain the ETR of thrifts at 31.28%. This was accomplished by reducing the PTI from 32% to 8% (92% of income taxable at the new corporate tax rate of 34% equals 31.28%). This change significantly "evened the playing field" between thrift and non-thrift financial institutions while continuing to encourage the thrift industry to maintain its unique position as the major provider of residential home mortgages.

With tax legislation as complex and far reaching as the 1986 Act, anomalies often arise between what was intended and what actually results when the new law is applied. The amendment affecting the PTI deduction for the 1987 taxable year is one such example. The timing of the reduction in the corporate tax rate was not matched with the timing of the reduction in the PTI percentage, causing most thrifts to incur a tax rate higher than 31.28% for tax years beginning in 1987. For example, a calendar year-end thrift will incur a 1987 effective tax rate of 36.8%. For non-calendar year-end thrifts, the 1987 effective tax rates will also vary from 31.28%; the extent of the variance depending upon the particular year-end.

This is clearly not the intended result. The legislative history evidences the desire to lower the corporate tax rate for non-thrift corporations while keeping the rate for thrifts the same. There is no stated or unstated policy reason which would justify a one year tax increase. We, therefore, propose a technical correction for this oversight that would bring the 1987 effective tax rate in line with the pre-1986 Act and post-1987 rate of 31.28%.

We would be happy to discuss this issue in more detail and to provide any additional information you may need. Please feel free to contact Michael J. Palko, Senior Vice President, Great Western Financial Corporation at 213/852-3349.

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July 22, 1987

Laura Wilcox
Hearing Administrator
Senate Finance Committee
205 Dirksen Senate Office
Building
Washington, D.C. 20510

Re: Passive Foreign Investment Company Provisions

Dear Ms. Wilcox:

The following is submitted for the record on S. 1350 on behalf of an ad hoc group of clients of Groom and Nordberg, representing a broad cross section of American industries, including pharmaceutical, electronics, natural resources and food products.

The 1986 Act created a new entity referred to as a Passive Foreign Investment Company ("PFIC"). Despite the reference in its name to passive income, the PFIC provisions, as enacted, apply to the active business income of a controlled foreign corporation ("CFC"), as well as to passive income. For the reasons discussed below, we believe that the application of these provisions to the active business of a CFC is inappropriate and beyond the stated purpose of the PFIC provisions.

The PFIC provisions, as enacted, apply to any foreign corporation, including a CFC, if 75 percent or more of its gross income for the year is passive income or if 50 percent or more of its assets (by value) produce passive income. Many CFCs (including wholly-owned subsidiaries) that are engaged in a substantial trade or business have substantial accumulated income and could "qualify" as PFICs.

In general, but for the PFIC provisions, the active business income of a CFC is not subject to U.S. taxation until this income is distributed to the U.S. shareholders. This basic concept of U.S. tax law is commonly referred to as deferral. On the other hand, the passive investment income of a CFC is subject to current taxation under the subpart F provisions. In addition, a CFC is subject to current taxation on income derived from a variety of activities for which Congress has concluded tax deferral is not justified. This income is generally referred to as foreign base company income. If the foreign base company income constitutes over 70 percent of the gross income of a CFC, all of the income of the CFC is subject to current taxation. Thus, subpart F contains a comprehensive set of rules concerning when the earnings of a CFC should be subject to current taxation. These rules do not generally eliminate deferral for active business income unless derived from base company or other specified activities.

The effect of the PFIC provisions is to eliminate deferral on all types of active business as well as passive income. A PFIC's shareholders are subject to an interest charge on all excess distributions from the PFIC. The charge is based upon the period of time that the amount distributed enjoyed the benefit of deferral. The charge, in effect, eliminates the benefit of deferral for these distributions, including distributions paid out of earnings derived from an active business. The only means of avoiding the interest charge is to become a qualified electing fund. In such a case, all income of the PFIC is currently taxed to its shareholders, including income derived from an active business.

Eliminating deferral on active business income is inappropriate for several reasons. It is a long-standing fundamental principle of international taxation followed by the United States (and all developed countries) that the earnings of a foreign corporation are not subject to U.S. tax until they are remitted to the U.S. shareholders. Numerous proposals have been made in the past to eliminate deferral for active business income. Congress, however, has always rejected these proposals. The principal reasons that these proposals have been rejected are as follows:

1. Practically all industrialized nations permit deferral for active business income of foreign subsidiaries until repatriated. Thus, if the United States eliminated deferral for active business income, there would be a higher tax burden on U.S.-owned foreign corporations than on foreign-owned companies. This would place U.S.-owned foreign subsidiaries at a competitive disadvantage and reduce the American share of these foreign markets. Since foreign-owned companies would seize the investment opportunities abroad, the loss of these markets would directly reduce domestic employment currently generated by supplying materials, technology, and supportive services to U.S.-owned foreign affiliates.

2. American companies that export substantial amounts of goods and products need to have significant overseas operations in connection with their U.S. production in order to minimize high tariffs and other export costs. The elimination of deferral for active business income would damage these companies' ability to export.

3. The elimination of deferral would increase the tax burden on subsidiaries of U.S. companies located in foreign countries which have low effective tax rates. Such countries would be encouraged to increase their taxes applicable to United States-owned enterprises because the total tax burden on the investment would not be changed, and the tax revenue which would otherwise go to the United States Treasury would be retained by the foreign country.

4. Deferral allows the tax incentives given by developing countries to be effective for foreign subsidiaries of U.S. companies. Denying these benefits will be resented by foreign governments as interference in their domestic affairs. Further, the impact will be more adverse for investment in developing countries than in developed countries. For example, Ireland is able to attract companies that wish to invest in a country in the European Economic Community (EEC) in order to avoid the high tariff on imports from non-member countries. If deferral is eliminated, these companies will still invest inside the EEC, but on the continent rather than in Ireland.

Consistent with longstanding U.S. policy favoring deferral, neither the House nor the Senate PFIC provisions would have subjected U.S. shareholders of CFCs to current taxation on their active business income. The House provision would have treated a PFIC as a CFC and would have treated each U.S. person who owns stock in a PFIC as a U.S. shareholder of a CFC. Thus, the House provision by extending the treatment of U.S. shareholders of CFCs to U.S. persons who own stock in a PFIC would have eliminated deferral for the passive income of a PFIC not otherwise subject to Subpart F. Moreover, the Senate provision contained an election that PFIC treatment would not apply if a U.S. person elected to be treated as a U.S. shareholder of a CFC. Thus, both the House and Senate bills would have eliminated deferral for passive investment income but not active business income.

The effective elimination of deferral on active business income is the fundamental defect associated with PFIC status. Given the fact that neither the House nor the Senate PFIC provisions would have subjected U.S. shareholders of CFCs to current taxation on active business income and the failure of the bill as approved by the Conference to provide for a section 902 credit and relief from double taxation of income that has been previously taxed under subpart F, it is fair to say that Congress paid little attention to the applicability of the PFIC provisions to CFCs.

The legislative history also demonstrates an intention to apply the PFIC provisions to tax passive investment income earned by foreign corporations where the subpart F provisions were not applicable. For example, the General Explanation states at pages 1023 to 1024:

- o Since current taxation generally is required for passive investments in the United States, Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation. Congress further believed that the nationality of the owners of controlling interests of a corporation which invests in passive assets should not determine the U.S. tax treatment of its U.S. owners. In Congress's view, the absence of U.S control did not necessitate preferential U.S. tax treatment to U.S. persons who invest in passive assets through a foreign corporation. Moreover, Congress recognized that U.S. persons who invested in passive assets through a foreign corporation obtained a substantial tax advantage vis-a-vis U.S. investors in domestic investment companies because they not only were able to avoid current taxation but also were able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income.

- o Under prior law, a U.S. investor may never have been fully taxed on his or her share of a foreign investment company's accumulated earnings. Congress noted that if similar income were generated by a domestic investment company or was otherwise currently subject to U.S. tax, the U.S. investor would have been taxed on the full amount of income. In Congress' view, if current taxation of a passive foreign investment company's actual income is required, U.S. investors should be taxed on their entire share of the company's earnings, regardless of whether the earnings are distributed.

Nowhere in the Reasons For Change portion of the General Explanation is there any reference to, or a policy discussion of, the taxation of the active business income of CFCs. Moreover, the revenue estimate of the provision, as enacted, is identical with the revenue estimate of the Senate provision and almost identical to the revenue estimate of the House provision. If there had been a clear understanding that active business income of CFCs would be taxed under this provision, as enacted, the revenue estimate would have been significantly increased.

For the reasons stated above, we do not believe it is sound policy to eliminate deferral for active business income. Even those that may have a contrary view would agree, we trust, that such a fundamental change should not have been made without specific acknowledgement and debate of the results of the change.

The purpose of the PFIC provisions was to eliminate deferral for passive income. To accomplish this purpose, it is unnecessary to apply these provisions to U.S. shareholders of CFCs because subpart F already eliminates deferral for passive income in this situation. If the PFIC provisions are applied to U.S. shareholders of CFCs, deferral is also eliminated for active business income of CFCs. We believe this result is unsound tax policy and was not intended by Congress. Accordingly, S. 1350 should exclude U.S. shareholders of CFCs from the application of the PFIC provisions.

Respectfully submitted,

Carl G. Nordberg Jr.

Carl A. Nordberg, Jr.

SUMMARY
STATEMENT
ON
H. R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987
BY
JOHN P. Z. KENT, DIRECTOR - FEDERAL/INTERNATIONAL TAXES
GTE SERVICE CORPORATION
SUBMITTED TO THE
TAXATIONS AND DEBT MANAGEMENT SUBCOMMITTEE
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 22, 1987

The Tax Reform Act of 1986, H. R. 3838, repealed the investment tax credit ("ITC") on a retroactive basis, effective January 1, 1986, and reduced its value and the taxpayer's ability to use it on a tax return to offset U. S. income tax liability, where it is still available, in several ways:

o By decreasing the amount of U. S. income tax that can be offset by ITC to 75% from 85%.

o By reducing the amount of ITC itself from 10% in 1986 and earlier years to 8.25% in 1987 and 6.5% in 1988 and succeeding years (to reflect the impact of the corporate tax rate reduction).

o By introducing a full ITC basis adjustment for transition property versus the one-half ITC basis adjustment under existing law.

This is a complicated area of the tax law involving a number of different provisions. Congressional intent, as enunciated in the Conference Committee Report, and general tax policy considerations would lead to the conclusion that the basis of property to be depreciated should not, in any case, be reduced by an amount that exceeds the ITC used on a tax return to offset U. S. income tax liability. An interpretation of the technical statutory language in this area of the Internal Revenue Code of 1986 leads one to the possibility that, where an ITC carryover from 1986 to 1987 or from 1987 to 1988 exists, the depreciable basis of property may be reduced by more than the amount of ITC being utilized by the taxpayer. An example of this "mismatching" would be a basis reduction of $10 on a $100 asset (eligible for ITC) placed in service in 1986 and an ITC carryover of $8.25 being claimed on a tax return in 1987 -- $1.75, in effect, is not eligible for ITC or depreciation. A taxpayer placing a $100 asset (eligible for ITC) in service in 1987 would make a basis reduction of $8.25 and claim an $8.25 ITC on a 1987 tax return. Further inequity could also occur in a disposition of an asset generating an ITC carried forward from 1986 to 1987 in an ITC recapture situation where the proper amount would not be restored to basis.

The most appropriate way to correct any possible misunderstanding with regard to this matter would be to revise Section 49 of the Internal Revenue Code of 1986 to allow for an "upward adjustment" in the basis of depreciable property for any reduction of allowable ITC that occurs in a carryover situation. This type of treatment is logical and consistent with legislative history in similar situations and achieves fairness in the treatment of similarly situated taxpayers that is one of the principal objectives of the Tax Reform Act of 1986.

STATEMENT
ON
H. R. 2636, THE TECHNICAL CORRECTIONS ACT OF 1987
BY
JOHN P. Z. KENT, DIRECTOR - FEDERAL/INTERNATIONAL TAXES
GTE SERVICE CORPORATION
SUBMITTED TO THE
TAXATIONS AND DEBT MANAGEMENT SUBCOMMITTEE
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 22, 1987

The Tax Reform Act of 1986, H. R. 3838, repealed the investment tax credit ("ITC") on a retroactive basis, effective January 1, 1986, and placed new limitations on the taxpayer's ability to use it to offset U. S. income tax liability, where ITC was still available due to a carryover situation or transitional relief. The tax reform legislation also reduced the value of ITCs from 10% in 1986 to 8.25% in 1987 and to 6.5% in 1988 and succeeding years for calendar year taxpayers in order to reflect the fact that the corporate tax rate is being reduced from 46% to 39.95% in 1987 and 34% in 1988. At the same time, the Tax Reform Act of 1986 reduced the value of ITC for "transition property" (basically, property placed in service after 1985 not eligible for or subject to the new modified depreciation system) by requiring a full ITC basis adjustment, as opposed to the one-half ITC basis adjustment of existing law. This full ITC basis adjustment means that the depreciable basis of property qualifying for transition relief is reduced by 10% in 1986, 8.25% in 1987 and 6.5% in 1988, consistent with the amount of ITC earned in those years.

Congressional intent, as enunciated in the Conference Committee Report, is certainly clear that the basis of property to be depreciated should be reduced by the amount of ITC being used to offset U. S. income taxes. The tax statute itself, however, is not clear that in the case of an ITC carryover from 1986 to 1987 or from 1987 to 1988 that the basis of property is reduced by the same amount as the ITC being actually used by the taxpayer on a tax return. In those two instances it is possible that the depreciable basis of property may be reduced by more than the amount of ITC utilized (for example, the basis could be reduced by 10% and the taxpayer only use an 8.25% ITC due to a carryover from 1986 to 1987). Clearly, this would be an inequitable result which is not consistent with the treatment of other ITCs being generated in the same year that the carryover ITC is being uitilzed and the intent of Congress in enacting this legislation. I have attached, as Exhibit A, a simple example which illustrates the possible "mismatching" that could occur between the depreciable basis of a capital asset investment and the related ITC utilized if this situation is not clarified and placed in its proper order by the Technical Corrections Act of 1987. Further inequity could also occur in a disposition of such asset in an ITC recapture situation where the proper amount is not restored to basis.

The most appropriate way to correct any possible misunderstanding with regard to this matter would be to revise Section 49 of the Internal Revenue Code of 1986 to allow for an "upward adjustment" in the basis of depreciable property for any reduction of allowable ITC that occurs in a carryover situation through The Technical Corrections Act of 1987. This type of treatment is consistent with legislative history in similar situations and achieves fairness in the treatment of similarly situated taxpayers that is one of the principal objectives of the Tax Reform Act of 1986. The technical correction could be accomplished in any number of ways and if the Subcommittee deems it appropriate, I stand ready to submit suggested statutory language.

I deeply appreciate the attention of this distinguished Subcommittee to this technical correction of the tax statute and respectfully submit that such correction is logical, fair and consistent with past and present legislative treatment and intent relating to ITC legislation.

Exhibit A

POTENTIAL EFFECT OF TAX REFORM ON
INVESTMENT TAX CREDIT (ITC) CARRYFORWARDS

IF YOU INVEST $100 IN A CAPITAL ASSET IN 1986 AND CLAIMED ITC IN 1986.

DEPRECIATION BASIS ADJUSTMENT		ITC	
$100.00	BASIS	$100.00	BASIS
($ 10.00)	BASIS ADJUSTMENT	10%	ITC
$ 90.00	ADJUSTED BASIS	$ 10.00	ITC

IF YOU MADE THE SAME INVESTMENT IN TRANSITION PROPERTY IN 1987 OR 1988.

CREDIT TAKEN	DEPRECIATION BASIS ADJUSTMENT		ITC	
1987	$100.00	BASIS	$100.00	BASIS
	($ 8.25)	BASIS ADJUSTMENT	8.25%	ITC
	$ 91.75	ADJUSTED BASIS	$ 8.25	ITC
1988	$100.00	BASIS	$100.00	BASIS
	($ 6.50)	BASIS ADJUSTMENT	6.50%	ITC
	$ 93.50	ADJUSTED BASIS	$ 6.50	ITC

IF YOU HAVE AN ITC CARRYFORWARD FROM 1986 AND CLAIM IT IN 1987 OR 1988.

CREDIT TAKEN	DEPRECIATION BASIS ADJUSTMENT		ITC	
1987	$100.00	BASIS	$100.00	BASIS
	($ 10.00)	BASIS ADJUSTMENT	8.25%	ITC
	$ 90.00	ADJUSTED BASIS	$ 8.25	ITC
	$1.75 NON DEPRECIABLE BASIS			
1988	$100.00	BASIS	$100.00	BASIS
	($ 10.00)	BASIS ADJUSTMENT	6.50%	ITC
	$ 90.00	ADJUSTED BASIS	$ 6.50	ITC
	$3.50 NON DEPRECIABLE BASIS			

HALE AND DORR
COUNSELLORS AT LAW

Ms. Laura Wilcox
United States Senate Committee
on Finance
SD 205
Dirkson Senate Office Building
Washington, D.C. 20510

Re: Technical Corrections Act
Interplay of At Risk Rules and
Rehabilitation Tax Credit Amendments

Dear Ms. Wilcox:

In connection with your consideration of technical corrections to the Tax Reform Act of 1986 (the "Act"), we are writing to bring to your attention two inconsistencies, and perhaps unintended consequences, of the provisions under Section 503 of the Act relating to the extension to real property of the at risk limitations (the "At Risk Rules"). As you know, by extending to real estate the At Risk Rules contained in Section 465 of the Internal Revenue Code (the "Code"), the at risk rules applicable to tax credits (the "Credit At Risk Rules") contained in Section 46(c)(8) of the Code apply to real estate. *See* I.R.C. §45(c)(8)(B).

Issue 1. Effect on Rehabilitation Tax Credits of Absence of a Transition Rule Under Section 503 of the Act.

The extension of the At Risk Rules to real property generally applies to losses incurred after December 31, 1986, with respect to property placed in service by a taxpayer after December 31, 1986. Act §503(c). In contrast, amendments made with respect to the rehabilitation tax credit provisions, which are generally effective for property placed in service after December 31, 1986, contain transition rules. Specifically, the amendments to the rehabilitation tax credit provisions do not apply to (1) property placed in service as rehabilitation property before January 1, 1994, if the rehabilitation was completed under a written contract binding on March 1, 1986, and (2) rehabilitation of property (including any leasehold interest) acquired before March 2, 1986 or acquired on or after that date, if (a) the rehabilitation was completed under a written contract binding on March 1, 1986, and a historic certification application was submitted to the Department of the Interior (or its designee) before March 2, 1986, or (b) the lesser of $1,000,000 or 5% of the rehabilitation cost was incurred before March 2, 1986, or is required to be incurred under a written contract binding on March 1, 1986. Act §251(d).

Based upon the foregoing, if the transition rules set forth in Section 251(d) of the Act apply, the reduced rehabilitation credit percentages contained in the Act do not apply. Despite such qualification, however, the taxpayer may not be permitted to utilize the greater amount of rehabilitation credits (or, for that matter, any rehabilitation tax credits) because of the absence of a transition rule under the At Risk Rules set forth in Section 503 of the Act. As a result, in many instances the transition rules under the rehabilitation tax credit rules do not produce a beneficial or intended effect.

For example, if a real estate project otherwise eligible for the grandfather provision provided in Section 251(d) of the Act had financing commitments prior to the Act providing for more than 80% leverage, it would not comply with the 80% test set forth in Section 46(c)(8)(D)(ii)(II) of the Code, described below, and therefore would not generate any rehabilitation tax credits.

As a further illustration, assume the renovation of a shell of a real estate property ("Project") is completed and placed in service in 1986. Assume further that tenant improvements were commenced in late 1986, but will be completed and placed in service in 1987. Because the shell of the Project was placed in service before January 1, 1987, any rehabilitation tax credits generated by it are not subject to the Credit At Risk Rules under Section 46(c)(8) of the Code. However, the tenant improvements will not be placed in service until 1987. Therefore, rehabilitation tax credits generated by the tenant improvements will be subject to the Credit At Risk Rules.

We believe that the purpose of providing a meaningful transition rule with respect to transactions generating rehabilitation tax credits is undermined by the omission of a transition rule in the At Risk Rules set forth in Section 503 of the Act. To eliminate this incongruity, we respectfully suggest that you amend the Technical Corrections Bill to include transition rules relating to Section 503 that are comparable to Section 251 of the Act. Such an amendment would be consistent with Section 209 of the Act, which provides that rehabilitation projects covered by the transition rules contained in Section 251(d) of the Act are exempt from the new extended depreciation periods applicable to real estate.

<u>Issue 2</u>. <u>Effect of Applying to Real Estate the Qualified Commercial Financing Test in Section 46(c)(8)(D) of the Code</u>.

As noted above, by extending to real estate the At Risk Rules contained in Section 465 of the Code, the Credit At Risk Rules contained in Section 46(c)(8) now apply to real estate. Under Section 46(c)(8)(D)(ii)(II), nonrecourse financing may not be included in the credit base if the total amount of nonrecourse debt on the property exceeds 80% of what would otherwise be the credit base of the property (the "80% Test"). Under Section 47(d) of the Code, the 80% Test will result in recapture of rehabilitation tax credits at any time in which indebtedness on a building is increased above 80%. Such a consequence would occur even though a taxpayer who sells (rather than refinances) a building would be subject to a declining amount of recapture during each of the first five years of ownership and no recapture after the fifth year of ownership. <u>See</u> I.R.C. §47(a)(5).

To eliminate the foregoing incongruous result, we respectfully suggest that you amend Section 47(d) of the Code as part of the Technical Corrections Bill to provide for a reduction or phase-out of investment tax credit recapture realized upon an increase in nonqualified nonrecourse financing. Such a reduction would be consistent with Section 47(a)(5) of the Code, which provides for a reduction or phase-out of investment tax credit recapture if a taxpayer sells property which generated investment tax credits.

If you have any questions or require additional information concerning this matter, please contact the undersigned.

Respectfully submitted,

Steven S. Snider

Steven S. Snider

SSS:sls

Harvard Medical School
25 Shattuck Street, Boston, Massachusetts 02115
(617) 732-1530

July 6, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I am writing on behalf of Harvard Medical School regarding the potential taxation of charitable gift annuities under Section 501(m) of the Tax Reform Act.

Gift annuities have been used in the charitable community for over 100 years. A donor decides to make his/her gift to help Harvard Medical School, not so that he/she will receive annuity payments. If the income payment was the primary concern, these individuals would be purchasing commercial annuity contracts whose payment rates are far more generous. Charitable gift annuities <u>are not</u> "commercial-type insurance", and therefore <u>do not</u> compete with commercial annuities.

One might look at the charitable gift annuity as being the equivalent of a wealthy donor's charitable remainder annuity trust, which is unaffected by Section 501(m). Because gift annuities are such an attractive form of giving for many who are unable to consider making a large gift (our minimum gift annuity amount is $5,000 while our annuity trust minimum amount is $50,000), failing to clarify the law would dry up an important source of funds for Harvard Medical School, as well as for all charitable institutions. We need your help in clarifying that Section 501(m) does not apply to gift annuities.

Please ammend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

Thank you.

Sincerely,

Jon E. Abrams

Jon E. Abrams
Director of Planned Giving

JEA/was

HARRIS, MERICLE & ORR
ATTORNEYS AT LAW

Ms. Linda Wilcox, Hearing Administrator
U. S. Senate
Room S-D 205 Dirksen Office Building
Washington, D. C. 20515

RE: Tax Reform Act of 1986 (P.L. 99-514) Section 633(d); Technical Corrections Bill of 1987 (H.R. 2636 and S. 1350) Section 106(g)(5)-(6)

Dear Ms. Wilcox:

Pursuant to Senate Finance Committee Chairman Lloyd Bentsen's invitation to examine and comment on the Technical Corrections Bill of 1987, which was introduced by Chairman Bentsen on June 10, 1987 as S. 1350, we submit the following written statement in support of delaying the effective date of the 5-year stock holding requirement of the special transitional rule provided for certain closely held liquidating corporations until June 10, 1987 (the date on which S. 1350 was introduced).

Prior Law

Under prior (as well as present) law, corporate earnings from sales of appreciated property were generally taxed twice, first to the corporation when the sale occurred, and again to the shareholders when the net proceeds were distributed as dividends. If the income to the corporation resulted from the sale of inventory or other ordinary income assets, the income was taxed to the corporation at ordinary rates. If the income resulted from the sale by the corporation of a capital asset held by it for more than 6 months, the income was taxable at capital gains rates. With certain exceptions, shareholders were taxed at ordinary income rates to the extent of their pro rata share of the distributing corporation's current and accumulated earnings and profits.

An important exception to the general rule discussed above generally permitted the non-recognition of gain by corporations on certain liquidating sales of corporate property and on certain distributions to shareholders of appreciated property.[1] The exception, commonly known as the "General Utilities doctrine,"[2] is based upon <u>General Utilities and Operating Co. v. Helvering</u>. Although the <u>General Utilities</u> case involved a dividend distribution of appreciated property by an ongoing business, the term "General Utilities rule" is often used in a broader sense to refer to the non-recognition treatment accorded in certain situations to liquidating as well as non-liquidating distributions to shareholders and to liquidating sales.

The <u>General Utilities</u> doctrine was reviewed by Congress and codified in Section 337 of the 1954 revision of the Internal Revenue Code of 1954 (hereinafter referred to as the "1954 Code"). Section 337 provided that if a corporation adopted a plan of complete liquidation and within 12 months of the adoption of the plan of liquidation distributed all of its assets in complete liquidation, gain or loss on any sales by the corporation during that period generally was not recognized by the corporation. Excepted from the Section 337 non-recognition provisions were sales of inventory (other than inventory sold in bulk), stock in trade, and property held primarily for sale to customers in the ordinary course of business. In addition, if a liquidating corporation accounted for its inventory on a LIFO basis, Section 337 required the amount of any LIFO recapture to be included in the corporation's income.

Present Law

The Tax Reform Act of 1986[3] (hereinafter referred to as the "Act"), provides that gain or loss is generally recognized by a corporation on a liquidating distribution of its assets as if the corporation had sold its assets to the distributee at fair market value. The distributee/shareholder is also subject to tax to the extent that the fair market value of the assets distributed exceeds the basis of the shareholder's stock in the liquidating corporation.

Although the repeal of the General Utilities rule is generally effective for liquidating sales and distributions after July 31, 1986, the Act provides a number of general transitional rules, some of which are based on actions before November 20, 1985 (the date of action by the House Ways and Means Committee), on actions before August 1, 1986 (the date of action by the Conference Committee), and on actions after July 31, 1986 and before January 1, 1987. With certain exceptions (i.e., depreciation recapture, investment tax credit recapture, ordinary gains or losses, gains from installment sales, gains or losses on capital assets held for less than six months, etc.) amendments made by the Act, including the repeal of the General Utilities rule and Section 337 of the 1954 Code, are inapplicable to transactions covered by the general transitional rules.

In addition to the general transitional rules, the Act specifically provides for a special transitional rule for certain small corporations.[4] Section 633(d) of the Act generally provides that in the case of the complete liquidation of a corporation on or before January 1, 1989, the amendments made by the Act concerning the recognition of gain by a corporation on a liquidating distribution of its assets will not apply if the liquidating corporation is a "qualified corporation." The term "qualified corporation" is defined by Section 633(d)(5) as any corporation if -

(A) On August 1, 1986, and at all times thereafter before the corporation is completely liquidated, more than 50 percent (by value) of the stock in such corporation is held by 10 or fewer qualified persons, and

(B) The applicable value of such corporation does not exceed $10,000,000.

The term "qualified person" means an individual, estate or any trust described in Section 1361(c)(2)(A)(ii) or (iii) of the Internal Revenue Code of 1986 (hereinafter referred to as the "Code").

As enacted and as cited above, the definition of a qualified corporation as codified in Section 633(d)(5) does not include or require that more than 50 percent (by value) of the stock in such corporation be held by ten or fewer qualified persons who have held their stock for a period of 5 years or longer.

Proposed Technical Correction Amendment

As proposed, Section 106(g)(5) of the Technical Corrections Bill of 1987 (hereinafter referred to as the "Bill") amends Section 633(d)(5) of the Act by deleting the words "10 or fewer qualified persons" and inserting in lieu thereof the phrase "a qualified group". Subsection 6 of Section 106(g) of the Bill provides the following definitions of the terms "qualified group" and "qualified person."

> (A) QUALIFIED GROUP. - The term "qualified group" means any group of 10 or fewer qualified persons who at all times during the 5-year period ending on the date of the adoption of the plan of complete liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) owned (or was treated as owning under the rules of subparagraph (C)) more than fifty percent (by value) of the stock in such corporation.
>
> (B) QUALIFIED PERSON. - The term "qualified person" means -
>
> (i) An individual,
>
> (ii) An estate, or
>
> (iii) Any trust described in clause (ii) or clause (iii) of Section 1361(c)(2)(A) of the Internal Revenue Code of 1986.

Section 119 of the Bill concerning the effective date of the technical corrections provides that "Except as otherwise provided in this title, any amendment made by this title shall take effect as if included in the provision of the Reform Act to which such amendment relates."

Detrimental Impact of Retroactive Amendment to Transitional Rule for Certain Small Corporations - Act Section 633(d)

In March of 1987 SP Energy Development Company, a limited partnership organized under the laws of the State of Washington and on whose behalf this statement is submitted (hereinafter referred to as "Spedco"), commenced negotiations with the sole shareholder of a group of small, related Oklahoma oil and gas corporations to acquire the assets of those corporations. Subsequently, in May of 1987, those Oklahoma oil and gas corporations adopted a plan of complete liquidation in reliance upon the transitional relief provided by Act Section 633(d). Pursuant to that transitional rule, the oil and gas corporations which were qualified corporations within the meaning of Act Section 633(d), were entitled to avail themselves of the Section 337 liquidation election provided under the Internal Revenue Code of 1954. In May of 1987, SPEDCO agreed to purchase all assets and assume all liabilities of the liquidating corporations for an aggregate purchase price of $1,500,000. The transaction was closed on June 5, 1987 and pursuant to the escrow instructions, all assets and proceeds were distributed at that time.

At all times during the negotiations and at the time of the adoption and actual liquidation of the corporations, the corporations were qualified corporations within the meaning of Act Section 633(d)(5) as enacted (i.e., on August 1, 1986 and at all times until the corporations were completely liquidated, all of the stock of such corporations was owned by one individual and the applicable value of each corporation did not exceed $5,000,000.)

As noted previously, current law as promulgated by Section 633(d) of the Act makes no reference to the Congressional Conference Committee Report requirement that a corporation will be eligible for the transitional rule only if its stock does not exceed $10,000,000 and more than 50% of its stock is owned by ten or fewer individuals who have held their stock for five years or longer. H. Rep. 99-841, Volume II, Page 206.

Where the meaning of a statute is clear and unambiguous on its face, it is a well-established principle that the statute should be interpreted literally and its legislative history should not be resorted to. Patagonia Corp. v. Bd. of Governors of Fed. Reserve Syst., 517 F.2d 803 (9th Cir. 1975); In re Parkwood, Inc., 461 F.2d 158 (D.C. Cir. 1971); C.I.R. v. Ridgeway's Est., 291 F.2d 257 (3rd Cir. 1961). The proper function of legislative history is to resolve ambiguity and not to create it.

> Where doubts exist and construction is permissible, reports of the committees of Congress and statements by those in charge of the measure and other like extraneous matter may be taken into consideration to aid in the ascertainment of the true legislative intent. But where the language of the enactment is clear, and construction according to its terms does not lead to absurd or impracticable consequences, the words employed are to be taken as the final expression of the meaning intended. And in such cases, legislative history may not be used to support a construction that adds to or takes from the significance of the words employed. (Emphasis Added).

U.S. v. Missouri Pac. R. Co., 278 U.S. 269, 278, 49 S. Ct. 133, 136 (1929).

Moreover, it has been held that an intentional omission of a word from a statute constitutes evidence that Congress did not intend to grant the power which the inclusion of the word or words omitted may have given. Shell Oil Co. v. Fed. Energy Admin., 400 F. Supp. 964 (D.C. Tex. 1975), aff'd. 527 F.2d 1243 (Temp. Emer. Ct. App. 1975).

On December 31, 1986, the Internal Revenue Service issued guidance in the form of Revenue Ruling 87-4, I.R.B. 1987-2, relating to the applicability of the transitional rule provided under Section 633(d) of the Act to complete corporate liquidations under Section 333 of the 1954 Code. The Internal Revenue Service determined that the language of the transitional rule for qualified corporations extended transitional relief not only to corporate-level gain under Section 337 corporate liquidations, but also with respect to gain which would otherwise be recognized at the shareholder-level as a result of a Section 333 liquidation. In reaching that determination, the Service reviewed the Section 633(d) transitional rule and specifically noted the following:

> Section 633(d)(5) of the Act generally defines "qualified corporation" as any corporation of which more than 50 percent (by value of the stock is held by 10 or fewer "qualified persons," as defined in Section 633(d)(6) and the applicable value of which does not exceed $10,000,000.

As noted previously, Section 633(d)(6) of the Act defines a qualified person as an individual, estate, or certain trusts.

Thus, not only did Spedco rely upon the definitions contained within the law as it existed at the time of the transaction and as it exists at present time, but so did the Internal Revenue Service in issuing its interpretation of the applicability of the transitional rule to certain qualified liquidating corporations. Based upon the transitional rule as promulgated in Section 633(d) of the Tax Reform Act of 1986, the cases cited above concerning statutory construction and interpretation, and the fact that the Internal Revenue Service relied upon the current definition of the term "qualified corporation" when it issued Revenue Ruling 87-4, Spedco, the selling Oklahoma oil/gas companies and similarly situated liquidating qualified corporations should be entitled to rely on the law as it currently exists.

In the event that Sections 633(d)(5) and (6) of the Act are retroactively amended to require a 5-year holding requirement by enactment of Section 106(g)(6)(A) of the Bill, Spedco's effective costs to purchase the assets of the Oklahoma corporations will be increased by approximately $400,000. Such additional cost will cause Spedco irreparable harm.

Proposed Amendment to Section 106(g)(6)(A) of the Technical Corrections Bill of 1987

Section 106(g)(6)(A) of the Technical Corrections Bill of 1987, H.R. 2636 and S. 1350 states as follows:

> "(A) QUALIFIED GROUP. - The term 'qualified group' means any group of 10 or fewer qualified person who at all times during the 5-year period ending on the date of adoption of the plan of complete liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) owned (or was treated as owning under the rules of subparagraph (C)) more than 50 percent (by value) of the stock in such corporation."

The following amendment to Section 106(g)(6)(A) of the Technical Corrections Bill of 1987, H.R. 2636 and S. 1350 is proposed:

> "Subparagraph (A) of Section 106(g)(6)(A) of the Technical Corrections to the Tax Reform Act of 1986 is amended by adding at the end thereof the following sentence:

> For the purposes of the preceding sentence, the requirement that more than 50 percent (by value) of the stock in such corporation be owned (or treated as owned) at all times during the 5-year period ending on the date of the adoption of the plan of complete liquidation (or, if shorter, the period during which the corporation or any predecessor was in existence) shall not apply if such corporation adopted a plan of complete liquidation prior to the date of enactment of this Act.

Revenue Effect

The Staff of the Joint Committee on Taxation estimated that the provisions requiring the recognition of gain or loss on liquidating sales and distributions (i.e., the repeal of the General Utilities doctrine) (Sections 631, 632 and 633 of the Act and Sections 336, 337 and 1374 of the 1954 Code) will increase fiscal year budget receipts by $15 million in 1987, $180 million in 1988, $348 million in 1989, $460 million in 1990 and $551 million in 1991.[6]

The amendment we recommend would have a revenue impact only during a part of fiscal year 1987. It would apply only to the very limited number of completed transactions where otherwise qualifying stockholders had not owned their stock for at least 5 years. There would be a very minimal effect on fiscal year 1987 budget receipts, and no revenue impact thereafter.

To alleviate the irreparable harm and inequity which will be caused by the retroactive enactment of a 5-year holding requirement to the special transitional rule for certain small corporations provided by Section 633(d) of the Act, we respectfully request that the applicability of the 5-year holding requirement of Section 106(g)(6)(A) of the proposed Bill be delayed until June 10, 1987 (the date on which H.R. 2636 and S. 1350 were introduced).

Should you have any questions or require any additional information concerning this issue, please do not hesitate to contact the undersigned or any of the persons listed in Exhibit A attached hereto. Your time and careful consideration of this matter is most appreciated.

Respectfully submitted,

HARRIS, MERICLE & ORR

Sanford Kinzer

Sanford Kinzer

Gloria Lung Wakayama

Gloria Lung Wakayama

Enclosure
cc: Mr. William Bennett, President,
Mr. Rick Freeman, Vice President,
SP Energy Development Company

[1] The term "appreciated property" as used herein refers to property whose fair market value or sales price exceeds its adjusted basis in the hands of the transferor corporation.

[2] General Utilities and Operating Co. v. Helvering Property, 296 U.S. 200 (1935).

[3] Tax Reform Act of 1986, P.L. 99-514.

[4] Section 633(d) of the Tax Reform Act of 1986, P.L. 99-514.

[5] Technical Corrections Bill of 1987, introduced June 10 as H.R. 2636 and S. 1350.

[6] General Explanation of the Tax Reform Act of 1986 as prepared by the staff of the Joint Committee on Taxation, May 4, 1987.

Exhibit A

PERSONS SUBMITTING WRITTEN STATEMENT:	HARRIS, MERICLE & ORR Sanford Kinzer, Esq. Gloria Lung Wakayama, Esq. 3210 First Interstate Center 999 Third Avenue Seattle, Washington 98104 Telephone: (206) 621-1818
ON BEHALF OF:	SP ENERGY DEVELOPMENT COMPANY Suite 1400 2201 Sixth Avenue Seattle, Washington 98121 Telephone: (206) 441-8313

SUMMARY OF COMMENTS AND RECOMMENDATIONS IN WRITTEN STATEMENT:

The Tax Reform Act of 1986, P. L. 99-514 (hereinafter referred to as the "Act"), provides that gain or loss is generally recognized by a corporation on a liquidating distribution of its assets as if the corporation had sold its assets to the distributee at fair market value. The distributee/shareholder is also subject to tax to the extent that the fair market value of the assets distributed exceeds the basis of the shareholders stock in the liquidating corporation.

With certain exceptions (i.e., depreciation recapture, ordinary gains or losses, gains from installment sales, etc.), the foregoing general rule does not apply to transactions covered by the special transitional rule for certain small corporations provided under Section 633(d) of the Act. As enacted and as it currently exists, Section 633(d) of the Act generally provides that in the case of the complete liquidation of a corporation on or before January 1, 1989, the amendments made by the Act concerning the recognition of the gain by a corporation on a liquidating distribution of its assets to its shareholders will not apply if the liquidating corporation is a "qualified corporation." As defined by Section 633(d)(5) of the Act, a corporation is a qualified corporation if, on August 1, 1986, and at all times thereafter before the corporation is completely liquidated, more than 50% (by value) of the stock in such corporation is held by 10 or fewer qualified persons and the applicable value of such corporation does not exceed $10 million dollars. The term "qualified person" means an individual, estate or certain trusts.

As proposed, Sections 106(g)(5) and (6) of the Techncial Corrections Bill of 1987 (H. R. 2636 and S. 1350), amend the transitional rule provided by Section 633(d) of the Act by replacing the term "qualified persons" with the term "qualified group." As defined in Section 106(g)(6) of the Bill, the term qualified group means any group of 10 or fewer qualified persons who at all times during the 5-year period ending on the date of the adoption of the plan of complete liquidation (or, if shorter, the period during which the corporation or any

1 The term "appreciated property" as used herein refers to property whose fair market value or sales price exceeds its adjusted basis in the hands of the transferor corporation.

2 General Utilities and Operating Co. v. Helvering Property, 296 U.S. 200 (1935).

3 Tax Reform Act of 1986, P.L. 99-514.

4 Section 633(d) of the Tax Reform Act of 1986, P.L. 99-514.

5 Technical Corrections Bill of 1987, introduced June 10 as H.R. 2636 and S. 1350.

6 General Explanation of the Tax Reform Act of 1986 as prepared by the staff of the Joint Committee on Taxation, May 4, 1987.

78-959 1083

predecessor was in existence) owned (or was treated as owning) more than 50% (by value) of the stock in such corporation.

To alleviate the irreparable harm and inequity which will be caused by the retroactive enactment of a 5-year holding requirement to the special transitional rule for certain small corporations provided by Section 633(d) of the Act, it is proposed that the applicability of the 5-year holding requirement of Section 106(g)(6)(A) of the proposed Bill be delayed until June 10, 1987 (the date on which H. R. 2636 and S. 1350 were introduced).

glw:g:35

Hercules Incorporated

Ms. Laura Wilcox
The Dirksen Senate Office Building
Room 205
Washington, D.C. 20510

Re: Treatment of Export Interest

Dear Ms. Wilcox:

Hercules Incorporated, Wilmington, Delaware is a multinational chemical corporation whose exports sales total $400-$500 million annually.

Over the past few years, it has become increasingly difficult to maintain our competitive market positions overseas. The primary factors are the relative strength of the dollar, the export financing facilities available to our competitors and various non-tariff barriers.

Hercules formed Hercules Finance Company Limited in 1985 overseas to provide more attractive financing to our overseas customers and other exporters.

By supplying attractive financing rates, this helped us compete more favorably with our overseas competitors. This Hercules financing facility also finances U.S. exports of other U.S. companies.

The Tax Reform Act of 1986 contains an exception to the subpart F provisions for export financing interest relating to the sale of inventory property of a related manufacturer. However, the provision as drafted is virtually meaningless because of its limitation to products of a related manufacturer and of a technical amendment made to section 864(d) of the Code which denies the export financing exception to sales of inventory property of a related manufacturer. Thus, the exception is limited to export sales of non-inventory property of a related manufacturer.

We recommend consideration of two items:

1) Remove the factoring provisions of Section 864(d) which seems to conflict with the export financing exemption provided for by the Tax Reform Act.

2) The export financing exemption is only available to related U.S. exporters. All U.S. exporters should be able to obtain favorable U.S. export financing whether related or unrelated to the overseas bank.

Enclosed is a more detailed technical memorandum.

Very truly yours,

Arden B. Engebretsen
Vice Chairman of the Board &
Chief Financial Officer

MEMORANDUM

Re: The Export Financing Exception For Subpart F Income In The 1986 Act Should Be Corrected Because As Drafted It Provides Virtually No Benefit For Exports

INTRODUCTION

For the purpose of assisting U.S. exports, the Tax Reform Act of 1986 contains an exception to the Subpart F provisions, in the case of a foreign bank, for export financing interest. This exception, however, is so narrow and questionably drafted that it provides essentially no benefit to export activities.

The exception does not apply to interest from the export financing of products produced by a person which is unrelated to the foreign bank. Further, it does not apply to interest from the export financing of any inventory property produced by a person related to the bank. The exception only applies to interest from the export financing of property initially manufactured by a related person for use in its own trade or business which it later exports.

Given the expressions of concern by the Congress over exports, it is difficult to believe that the Congress would approve an export financing exception that benefits virtually no exports. In order to make the export financing exception meaningful, in the case of a foreign bank, it is recommended that the provision be amended to apply to sales of inventory by related and unrelated persons.

BACKGROUND

The 1984 and 1986 Tax Acts have almost totally eliminated the tax benefit of deferral for a foreign bank in financing the export of U.S.-made goods of related and unrelated persons. Prior to these Acts, a foreign bank could finance the sale of export products of related and unrelated persons and the profits therefrom would not be subject to U.S. tax until distributed to the U.S. shareholders as a dividend.

Unrelated Persons - Before the 1986 legislation, interest received by a foreign bank in connection with the financing of export sales of unrelated persons was not subpart F income because the banking exception to the foreign personal holding income rules applied. The 1986 Act eliminated the banking exception. The Conference Report appears to indicate an intention that the change was not intended to have a negative impact on exports. It states that an exception for interest from export financing was included because of "concern that this tax reform legislation might otherwise have the effect of reducing the availability of export financing in some cases, which could, in turn, have a negative impact on the volume of exports". (Conference Report at 565.) However, the exception provided in the 1986 Act does not apply to exports of unrelated persons and thus, contrary to the objective stated in the Conference Report will adversely impact exports.

Related Persons - Before the 1984 legislation, interest received by a foreign bank in connection with the financing of exports sales of related persons was not foreign personal holding income because the banking exception applied. The 1984 Legislation was intended to treat factoring income from factoring a related persons trade receivables as interest income because factoring was the functionally equivalent of interest income*.

The solution to the problem was to provide in section 864(d) that income from the factoring of a trade receivable is to be treated as if it were interest earned by the factor on a loan to the obligor of the receivable.

Moreover, factoring income was denied the banking exception to foreign personal holding company income. There was no reason given for treating interest income of a foreign bank from financing the sale of related persons' products as not being entitled to the banking exception. Once factoring is characterized as interest income, there is no justification for treating factoring any different than other forms of interest income. Moreover, the 1984 legislation provided that an actual loan to an unrelated person to finance sales of a related person's goods is to be treated as if it were factoring income. That is, it is to be treated as income from a factoring transaction. Of course, since factoring income is treated as interest income, the income is treated as interest income which is not eligible for the exception to subpart F income.

Finally, the 1986 Legislation appears to provide an exception to foreign personal holding income for interest from the financing of the export sale of U.S. products manufactured by a related person. However, the exception does not apply to the sale of inventory products, because the rules adopted in 1984 were made applicable the export financing exception. It is incongruous to provide an exception for exports of products of related persons and then to provide that the exception does not apply to inventory property. If there was an intention to assist the export of U.S.-made goods by providing an export financing exception, it clearly must have been intended by the policymakers that the exception applies to sales of inventory property.

IMPORTANCE OF EXPORT FINANCING

Attractive export financing rates is a key element in the sale of goods. Many foreign governments provide significant assistance to their manufacturers in making exports sales by providing export financing at a lower than market rate. The United States Export-Import Bank does not provide short-term export financing assistance to U.S. exporters. Thus, the burden of providing competitive financing rates falls on the U.S. manufacturer wishing to make the export.

There are very few products, if any, where U.S. manufacturers are not facing stiff competition as to quality and price from foreign manufacturers. Thus, providing favorable financing rates helps U.S. companies compete with overseas manufacturers. This is true regardless whether export financing is being provided to facilitate the sale of related persons' goods, or the export of goods made by other U.S. companies.

The ability to defer U.S. tax on export financing interest until the income in repatriated has in the past permitted U.S. companies to establish foreign banks to provide export financing at a rate competitive with foreign overseas competitors. The 1984 legislation and the 1986 legislation has totally eliminated the ability of foreign banks owned by U.S. companies to provide favorable export financing. Thus, while concern is generally expressed over the U.S. balance of trade and the impact of the U.S. tax laws on exports, during the past two years amendments have been made to the tax law which totally hinders the ability of U.S. companies to provide competitive export financing.

RECOMMENDATIONS

In order to assist U.S. companies in the export of U.S.-made goods, it is recommended that the export financing exception for foreign banks be amended so that it applies to interest from the export financing of inventory product produced in the United States by related and unrelated persons.

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* Under prior law, the Internal Revenue Service had held that income from the factoring of a receivable was service income and not interest for purposes of the subpart F provisions of the Internal Revenue code. Accordingly, the factoring income was not included as personal holding company income. The General Explanation states that a "factoring transaction is a financing transaction in which the factor has assumed a loan to the obligor on the account receivable and the discount earned by the factor is functionally the equivalent of interest. By structuring the transaction as the factoring of a receivable rather than as a loan, however, the parties could significantly alter the tax consequences of the transaction and, in particular, could plan around anti-abuse rules of prior law." (General Explanation at 365.)

THIS PAGE CONTAINS BOTH SUMMARY AND COMMENT ON CAPITAL GAINS TREATMENT FOR PRE-EXISTING INSTALLMENT SALES CONTRACTS

TO: Committee on Finance
United States Senate

RE: Public Comment on TECHNICAL CORRECTIONS ACT of 1987

SENATORS:

Pre-existing real estate installment sales contracts should be "grandfathered in" for purposes of the 60% long-term capital gains exclusion.

In 1984, I sold a real property on a five-year installment sales contract. Because I had owned the property since 1979, the sale qualified for the long-term 60% capital gains exclusion for income tax purposes.

But now, halfway through the contract, you declare that 100% is taxable, which will create a severe tax burden for me and countless other small investors, even at the so-called "lower" tax rates.

The 1986 Tax Reform Act changed the rules halfway through the game. This is akin to an ex post facto law and is grossly unfair. If you want to make long-term capital gains 100% taxable, so be it. But, be FAIR about it and grandfather in the installment sales contracts that were in existence prior to the passage of this law. Pre-existing installment sales contracts should still receive the 60% long-term capital gains exclusion.

Susan Hood, ordinary tax-paying citizen

Susan Hood
10508 E. Mission Lane
Scottsdale, AZ. 85258

THIS PAGE CONTAINS BOTH SUMMARY AND COMMENT ON MORTGAGE INTEREST DEDUCTIBILITY WHEN REFINANCING HOME FOR PURPOSES OF RESALE.

TO: Committee on Finance
United States Senate

RE: Public Comment on TECHNICAL CORRECTIONS ACT of 1987

SENATORS:

I am concerned over the 1986 Tax Reform Act's rules regarding refinancing your principal residence. As I understand, the new law states that the interest on the new mortgage amount over the adjusted basis of the home is NOT deductible unless the proceeds are used for medical or educational purposes. In my opinion, this is too restrictive, particularly for those people who are trying to sell their homes.

This spring I put my house up for sale. It had an old mortgage with a very low balance; the high equity made it virtually unsaleable. So I decided to refinance it and offer it for sale with a new high-balance, low-down mortgage. I had the house sold on a "wraparound" where I would receive payments from the buyer at 9½%, then I in turn would pay on the new loan at 9¼%.

However, I ran into this problem: the interest income from the buyer's payments to me was fully taxable but the interest I paid out on the new "underlying" mortgage was not fully deductible. I could deduct only the interest up to the adjusted basis of the house, which was far below the current market value. This hitch killed the sale, because I could not afford to have fully taxable interest income with only partially deductible interest expense.

Could you revise the law to remedy this situation? For instance: "If refinancing is for purposes of selling the home, then all interest on the new mortgage will be fully deductible." As the law is now, it severely limits the seller's creative financing alternatives.

Susan Hood, ordinary tax paying citizen

Susan Hood
10508 E. Mission Lane
Scottsdale, AZ. 85258

HODGSON, RUSS, ANDREWS, WOODS & GOODYEAR
ATTORNEYS AT LAW

TREATMENT OF OPTIONS AND WARRANTS UNDER SECTION 382 OF THE INTERNAL REVENUE CODE

SUMMARY

The following comments concern the treatment of options and warrants under Section 382 of the Internal Revenue Code of 1986 and the proposed amendments by the Technical Corrections Act of 1987. We believe that clarification is necessary to ensure that the operation of the deemed exercise rule is consistent with the purposes underlying Section 382 and to prevent illogical results in the case of certain options and warrants.

The first situation involves options or warrants issued prior to the beginning of the testing period that have a zero exercise price. With a zero exercise price the option or warrant holder is in economic reality an owner of the corporation as of the beginning of the testing period. Thus, a clarification should be made that options, warrants or similar rights that have a zero exercise price as of the beginning of the testing period should be treated as stock at all times during the testing period whether deemed or actually exercised.

This clarification also should apply to options, warrants or similar interests that are issued prior to the testing period and are not transferred during the testing period, but which have an exercise price greater than zero. If the option or warrant is deemed exercised during the testing period, the implicit assumption is that the option in economic substance is an ownership interest. There is no justification for limiting this assumption to the instant when a change of ownership would result. Thus, the deemed exercise should relate back to the date of acquisition of the option or warrant, resulting in no increase in ownership during the testing period as a result of the deemed exercise and establishing a consistent base line or testing period ownership structure. The same result should apply if the option or warrant is actually exercised. Actual exercise only reinforces the assumption of ownership in economic reality.

The proposed Technical Corrections Act of 1987 would amend the deemed exercise rule of Section 382 to eliminate the reference to Section 318(a)(4). The Staff of the Joint Committee states in its General Explanation of the Tax Reform Act of 1986 that the change is necessary to prevent options on unissued stock from escaping the ambit of Section 382. Since the amendment is substantive in nature, its application should be prospective. Particularly in light of the intricacy of Section 382, transactions planned and implemented based on existing law should not be upset by the Technical Corrections Act.

These issues are central to the operation of Section 382 and require immediate guidance. We respectfully request that these issues be resolved by Congress and not be left to the Treasury Department's regulatory authority.

TREATMENT OF OPTIONS AND WARRANTS UNDER SECTION 382 OF THE INTERNAL REVENUE CODE

DISCUSSION

We are pleased to provide the following comments regarding Section 382 of the Internal Revenue Code of 1986 and the proposed amendments by the Technical Corrections Act of 1987. We believe these comments are consistent with the goal of Section 382, to limit the carryover of tax losses following a change in the ultimate beneficial ownership of the corporation during the testing period, and thereby eliminate "trafficking" in tax losses.

Our comments relate to the treatment of warrants and options which occurred in the following situation. In July 1986, our client, a domestic corporation (Acquiring) purchased 25% of the stock of an unrelated domestic corporation (Target 1) from its owner (O), and received from Target 1 warrants to purchase unissued Target 1 stock. At that time, Target 1 had significant net operating loss carryforwards. Due to the uncertain value of Target 1 as of the acquisition date, the exercise price of the warrants was determined by a formula based on the net capital of Target 1, without regard to its net operating loss carry-forwards.

Acquiring assigned 20% of its then 25% Target 1 stock interest and 20% of the Target 1 warrants to two unrelated business organizations (A and B). By December 1986, Acquiring's accountants had determined that the net capital of Target 1 was such that the exercise price of the warrants would be zero. In December 1986, Acquiring purchased the remaining 75% of the stock of Target 1 from O and simultaneously granted A and B an option to acquire 20% of that 75% interest. Since the exercise price of the warrants to acquire Target 1 stock equaled zero, exercise of the warrants was a mere formality. On January 31, 1987, the exercise of the warrants was completed for no cost and additional Target 1 stock was issued to A and B. Shortly thereafter A and B exercised their option to purchase 20% of Acquiring's 75% interest as well and became full 20% shareholders in Target 1.

In February 1987, Target 1 granted an option to a domestic corporation (C) to acquire unissued stock of Target 1 sufficient to give C a 20% interest in Target 1. In March 1987, Target 1 began negotiations to acquire all of the outstanding stock of a domestic corporation (Target 2) in exchange for a combination of cash and Target 1 stock.

The Target 2 acquisition can only be accomplished if a significant amount of the equity of Target 1 can be offered to Target 2 shareholders and to persons who will provide the cash necessary to buy out the remaining Target 2 shareholders. In order to determine the amount of Target 1 equity that is available for the Target 2 acquisition without triggering a change of ownership of Target 1 under Section 382, several questions have arisen regarding the proper treatment of the warrants and options granted to A, B and C to acquire Target 1 stock. The most important of these questions lies in the determination of the "base line" ownership of Target 1 in December 1986 to enable Target 1 to decide what will constitute a 50% increase in the ownership of its shareholders under Section

382. Are A and B's no cost warrants which were converted to stock in early 1987 considered stock equivalents for purposes of determining their percentage ownership in December 1986? What about the options granted by Acquiring in favor of A and B in December 1986 which were also later exercised? Does the option given to C on unissued stock of Target 1 contribute to a potential change of ownership, or should the rules of Section 318 apply to require that these options be disregarded until exercised?

1. The General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation (p. 311, fn. 32) states that, "[i]t is expected that the Treasury Department may consider whether there are circumstances in which it may be appropriate to limit the operation of [the deemed option exercise] rule to transactions occurring during any three-year testing period that includes the date the option or other interest is issued or transferred." We request that the committee reports for the Technical Corrections Act of 1987 clarify that Congress expects the Treasury Department to consider as exercised from the date of issuance options, warrants or similar rights issued before the beginning of the testing period that have a zero exercise price as of the beginning of the testing period and that are not transferred during the testing period. Moreover, if the warrant or option ultimately is exercised during the testing period, the warrant or option should be treated as exercised as of the beginning of the testing period.

The conversion of a no cost warrant or option to a share is a mere formality without economic effect, and thus should be treated as such. The purpose of Section 382, to limit the carryforward of net operating losses following an ownership change during the testing period, would be thwarted if the exercise (deemed or actual) of the no cost warrant or option were treated as an increase in ownership. The no cost warrant or option holder was in economic reality an owner of the corporation as of the beginning of the testing period and should be so treated.

The effect of this clarification on the acquisition of Target 2 by Target 1 would be to make more certain the base line ownership percentages against which later changes could be measured. It is noteworthy that if the impact of Section 382 had been understood fully prior to the end of 1986, A and B clearly would have exercised the no cost warrants at that time in order to increase their base line ownership.

2. Section 382(l)(3)(A)(iv) generally provides for the deemed exercise of warrants and options if an ownership change would result. The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation (at p. 311, fn. 32) indicates that, if an option is deemed exercised, the shareholder will be treated as owning the stock on <u>and</u> after the date on which the option is acquired or is later transferred. It is not clear which is intended, that the deemed exercise of an option relate back to the date of acquisition by the option holder, or that the option is deemed exercised only at the instant that a change of ownership would occur. We believe that the first interpretation is correct as a matter of economic substance, consistency and sound tax policy. In addition, it

must follow that if the deemed exercise of an option relates back to the acquisition date of the option, the actual exercise of an option also must relate back to the acquisition date.

The deemed exercise of an option rule recognizes that, in most cases, an option on stock and a share of stock are economically indistinguishable.[1] Consistency requires that an option treated as an ownership interest be treated as such from the date of acquisition. There is no justification for limiting the deemed exercise of an option to a moment in time based on changes in ownership interests among other shareholders. We recognize that in certain instances, options may be issued which were never intended to be exercised in order to circumvent the Section 382 limitations. We suggest that the proper method for dealing with such abuse would be to ignore options that do not qualify as such in economic substance.

Further, the relation of the deemed exercise of an option back to the date of acquisition of the option is analogous to the provision under Section 382 that allows the loss corporation to file amended tax returns for prior years if an option expires without being exercised, but the existence of the option resulted in an ownership change and net operating loss carryforward disallowance. If the expiration of an option is treated as relating back to correct mistaken assumptions about the substance of an ownership interest in the corporation, the same rule should apply to a deemed exercise of an option.

Finally, a deemed exercise rule that is limited to the instant when a change of ownership would result effectively extends the testing period beyond the statutory boundaries. An option issued with a ten year term could contribute to an ownership change at any time during its ten year life, spanning four (and possibly five) three year testing periods. The policy underlying the limitation on the carryforward of net operating losses has always recognized the need to limit the time period for measuring changes in ownership. Section 382 as amended by the Tax Reform Act of 1986 extended the time period to three years. The Technical Corrections Act of 1987 should clarify that an exception to the three year testing period was not intended in the case of options.

Assuming that the deemed exercise of an option acquired before the testing period relates back to the acquisition date (and thus does not cause an increase in percentage ownership), then the actual exercise of the option also should relate back to the acquisition date. The alternative conclusion, that the actual exercise of an option does not relate back, is illogical. The deemed exercise of an option assumes the economic substance of the ownership interest represented by the option. If the assumption of economic substance relates back in the case of a deemed exercise of an option, then the same result must apply where the economic substance is proven by the actual exercise of the option.

The effect of the relation back rule to the factual situation described above would result in an increase in the percentage ownership of Target 1 by A and B as of the base period date. Thus, following the exercise of the options and warrants acquired in 1986, A and B would experience a smaller increase in percentage ownership from the base period date to the date of exercise. This would allow Target 1 to use more of its equity to acquire Target 2 without causing a change of ownership.

3. Section 382(l)(3)(A)(iv) as enacted by the Tax Reform Act of 1986 provided for the deemed exercise of options in accordance with Section 318(a)(4) (if an ownership change would result). As recognized by the Staff of the Joint Committee in its General Explanation of the Tax Reform Act of 1986 (at p. 311, fn. 33), case law supports the view that, in certain circumstances, options on unissued or treasury stock are disregarded under Section 318 (a)(4). In order to correct this apparent defect, the proposed Technical Corrections Act of 1987 amends Section 382(l)(3)(A)(iv) to eliminate the reference to Section 318(a)(4) and to treat all options to acquire stock as deemed exercised if a change of ownership would result. Although we do not oppose the amendment, we believe that the change is substantive and should be limited to options issued on or after the date of introduction of the Technical Corrections Act. We request clarification in the committee reports that options on unissued stock granted prior to the date of introduction would be ignored for purposes of Section 382(l)(3)(A)(iv).

The effect of this clarification on the acquisition of Target 2 would be to ignore the option granted to C and thereby increase the equity of Target 1 available for the acquisition of Target 2 without triggering a change of ownership. Although the proposed amendment may be appropriate, its retroactive application would unfairly upset transactions planned in reliance upon existing law.

Due to the likely delay in the issuance of regulations and the need for guidance to complete transactions, we respectfully request that resolution of these issues not be left to the Treasury Department's regulatory authority.

Dated: July 16, 1987

1/ A share of stock is economically equivalent to an option. Black F., M. Scholes "The Pricing of Options and Corporate Liabilities" Journal of Political Economy, May/June 1973, pp. 637-659. A share of stock represents the right to the liquidation value of a corporation after payments due to creditors. The exercise price of this "option" is zero and the strike price is the amount owed to creditors. Since an option on stock grants the holder and option to become a shareholder, it is merely an option on an "option."

Squire, Sanders & Dempsey

HAND DELIVERED

Ms. Laura Wilcox
Hearing Administrator, U.S. Senate
Committee on Finance
Room SD205
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments on S.1350, Technical Corrections Act of 1987, Effect of 1986 Tax Reform Act Retroactive Repeal of Investment Tax Credit on Horizon Air

This statement explains an unusual and totally unforeseen problem now facing Horizon Air Industries, Inc. d/b/a Horizon Air, a large commuter air carrier based in Seattle, Washington, as well as its parent corporation, Alaska Air Group, Inc. also headquartered in Seattle. The problem arises from the retroactive repeal of the investment tax credit which under the legislative history of the 1986 Tax Reform Act was not supposed to adversely affect contracts entered into prior to January 1, 1986. However, because of the unusual confluence of circumstances set forth below, Horizon will be deprived of any investment tax credit unless a technical correction addressing Horizon Air's problem is included in H.R. 2636.

The relevant facts are next discussed.

On August 30, 1985, Horizon Air Industries ("Horizon") entered into a contract for the purchase of ten new DHC-8 aircraft from The De Havilland Aircraft of Canada Limited ("De Havilland") at a cost of $5.55 million each (total purchase price of $55.5 million). Horizon made a downpayment of $1 million on the contract. Expected delivery dates were December 1985 through November 1986. Horizon agreed to assign the purchase contracts to UT Financial Services Corporation ("UT Financial") in December 1985 and to lease the planes back from UT Financial. The leases contemplated that UT Financial would be entitled to an investment tax credit of 10 percent of the cost of each plane and provided that, if such credits were not available, Horizon would pay an increased monthly rent to UT Financial over the 14 year lease term.

The Tax Reform Act of 1986 retroactively repealed the investment tax credit for property placed in service after 1985 unless certain transitional rules applied. Horizon satisfies one of the statutory transitional rules since it had a binding contract to purchase the aircraft prior to December 31, 1985. However, the Conference Report states that the "binding contract" exception is not available if a contract has a liquidated damages clause providing for damages of under 5 percent of the contract price. Since the Horizon-De Havilland contract limited damages to the $1 million downpayment (roughly 2 percent of the contract price), it would not be considered "binding" under that report, despite the fact that $1 million is by no means a minimal amount of damages.

The obvious policy behind the Conference Report is to require that payments under a liquidated damages clause in a purchase contract be significant enough such that the buyer will not easily "walk away" from the contract. Only under such circumstances can a contract truly be considered binding. In implementing this policy, the Conference Report assumed that a 5 percent damages clause would ensure that a buyer would not default on a contract. However, in the context of a company such as Horizon, those same policy considerations are satisfied in the instant case. Clearly Horizon was not going to walk away and leave $1 million on the table. Horizon's average operating revenues for its 1984 and 1985 fiscal years were only $51 million and it had an average net operating profit of only $1.15 million for those same years. The $1 million downpayment was extremely significant to Horizon and ensured it would honor this contract, as in fact, it did. Obviously, this contract was binding on Horizon when it was signed in 1985 in every real sense of the word.

Nine of the ten planes were in fact placed in service during 1986 (one each in February, March, June, September and November and four in December) and Horizon is paying additional monthly rents of approximately $58,900 because of the unavailability of the investment credit. Over the fourteen-year lease term, Horizon will be required to pay approximately $9.9 million in additional rents, which costs must be passed on to air travel customers in the Northwest United States. To the extent the costs cannot be passed on to customers, Horizon will have to reduce its employee or other costs to remain competitive, thus setting off significant repercussions among Horizon's almost 1000 employees in the states of Washington, Oregon, Idaho, Montana and Utah.

In April 1987, UT Financial exercised its contractual right to lock-in the higher monthly lease payments predicated on the assumption that the investment tax credit would not be available. However, UT Financial also transferred to Horizon the right to pursue the investment tax credit to which Horizon believes it should be entitled. If Horizon Air can realize the investment tax credit on these 10 aircraft which it most certainly deserves and thereby partially offset the now permanent higher lease payments Horizon is required to pay UT Financial, that savings can be passed on to its customers in the form of fare reductions as well as helping Horizon's employees and the many businesses which rely on Horizon.

Sincerely yours,

Marshall S. Sinick

Marshall S. Sinick

cc: Honorable Charles A. Vanik
William Diefenderfer, Esq.

MSS:mc
Enclosure

LAW OFFICES
HUFFMAN ARRINGTON KIHLE GABERINO & DUNN

Ms. Laura Wilcox
Hearing Administrator
Senate Finance Committee
United States Senate
Room 205
Dirksen Senate Office Building
Washington, D. C. 20510

Re: Section 111B(i), H.R. 2636/S. 1350
Technical Corrections Act of 1987

Dear Ms. Wilcox:

We join the reported position of numerous other commentors on the provisions of Section 111(B)(i) of H.R. 2636/S. 1350 that a "technical correction" should not be made to limit distributions in the case of termination of a tax credit ESOP under section 409(d)(1) of the Internal Revenue Code of 1986.

In particular, it is respectfully submitted that a limitation or denial of distributions upon termination of a tax credit ESOP because the employer has a separate and pre-existing defined contribution plan is not consistent with the legislative history of the Tax Reform Act of 1986.

The intendment of Section 1174(a)(1) of the Tax Reform Act of 1986, is to promote administrative ease and reduce complexity in the tax laws by eliminating the tax credit ESOP distribution restrictions in any case of termination.

The proposed change will have the opposite effect. It will unduly complicate planning for employee benefits by both employers and employee participants, especially in cases where employers have already initiated the restructuring of their benefit programs to take into account the ESOP rules enacted by the Tax Reform Act of 1986.

If this type of change is to be made by a technical correction, a grandfather provision or exception should certainly be afforded to permit employers to proceed with distributions pursuant to ESOP terminations which have been effected or authorized prior to the enactment of a Technical Corrections Act.

In addition, a distribution upon tax credit ESOP termination at a participant's election should be allowed in any case where the participant may also elect, in the alternative, to have distribution deferred by rollover or transfer of ESOP assets to the trust of another qualified employer plan. That approach will permit a terminated tax credit ESOP participant to continue with qualified plan retirement savings. At the same time, there will be more uniformity in treatment of plans, and employers will not be arbitrarily burdened with a requirement of maintaining and administering duplicative plans, which, after an otherwise permissible ESOP termination, will not provide measurable additions to benefits in the form of stock ownership or savings.

Very truly yours,

Sheppard F. Miers, Jr.
For the Firm

Supplemental sheet to statement submitted by John B. Huffaker, Esquire relating to Interest on Estate Taxes on Vested Remainders Postponed Under Section 6163.

The following information is supplied pursuant to the formatting requirements for printing of written comments with respect to S. 1350.

Statement submitted by:

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Name of Clients: Executor of the Estate of Mary P. Benson and the Executor of Estate of Eleanor P. Morris.

Summary

Payment of Estate taxes on vested remainders can be postponed by the executor of the remainderman until he is entitled to receive the trust principal. Interest accrues at the rate applicable to tax deficiencies and the rate changes each quarter as the rate on three-month Treasury bills changes. Because the value of the remainder is computed using the discount rate in effect when the remainderman died, there is a severe hardship on estates which have a high value for the remainder (hence a high tax) due to the use of a low discount rate (such as the 3 ½% rate in effect before 1975) but are subject to a high rate of interest accrual (such as the current 9% rate). The interest is equal to over a 30% rate on a tax computed under the current discount rate.

We request that the interest rate be fixed for the period the estate tax is postponed at a rate that bears a rational relation to the discount rate used to compute the tax. The cases of severe hardship are those in which the value of the remainder interest is over 50% of the adjusted gross estate because the executor will not have an alternative to postponing the payment of interest and tax. Therefore, the requested relief is limited to such cases.

Re: Amendment to Sec. 1511 of the Tax Reform Act of 1986 Relating to Interest on Estate Taxes on Vested Remainders Postponed Under Section 6163.

I. Introduction

This statement is submitted by John B. Huffaker as counsel for the Executor of the Estate of Mary P. Benson and the Executor of the Estate of Eleanor P. Morris. The decedents were sisters, the former dying in 1964 and the latter in 1966.

Sec. 1511 of the Tax Reform Act of 1986 changed the way that interest on unpaid taxes, including estate tax, is computed. It provided for interest to vary quarterly (instead of semi-annually) to reflect the current rates on three-month Treasury bills and created a 1% addition to the interest charged taxpayers as compared with the interest on refunds. This differential reflects the underlying concept that the deferral is a series of short term loans by the Treasury to the taxpayer (or by the taxpayer to the Treasury in case of overpayments).

We urge that the 1986 Act be changed to recognize that in certain limited circumstances the "loan" should be viewed as a long term loan at a rate of interest fixed at the time the tax liability is incurred. We believe that current law imposes an unintended hardship when the major asset of an estate is a vested remainder and the payment of the tax and interest is deferred pursuant to Section 6163.

A vested remainder occurs when the decedent had the right to receive the corpus of a trust upon the termination of another person's prior right. Both of the estates upon whose behalf this statement is submitted involved this fact pattern that is, a father established a trust for each of his two daughters subject to a life estate in their mother and both daughters pre-deceased their mother who is still living.

Thus the vested remainder is an asset to be valued in each daughter's estate and a tax computed. However, in recognition of the fact that the trust is not available as a source for payment of the tax, the executor may postpone payment of the tax under Section 6163 until mother's death. This provision has been part of our estate tax since its inception. Interest accrues on the unpaid tax -- our request is for Congress to provide a special rule for computing the interest. A special rule was provided until 1975.

When the vested remainder is a large part of the estate, the deferral is involuntary because the executor does not have assets available to pay the tax. In the above example, assuming one daughter had died in 1964 (as actually happened), by current date the tax plus the accrued interest would be in excess of the value of the trust principal when the daughter died.

II. Valuation and Taxation

A vested remainder is valued by formula at the date of death, taking into account (1) the market value of the trust principal, (2) the life expectancy of the income recipient and (3) the discount rate set by the Treasury.

1. Discount Rate

The discount rate at the date of death is critical to the tax burden. A small discount means a bigger value and a bigger tax; a big discount means a smaller value and a smaller tax. The discount rate was 3½% prior to 1975, then 6%, and, since 1983, 10%. The discount rate is established by the Treasury.

2. Deferral Interest Rate

Deferral interest accrues on the estate tax postponed. Prior to 1975 a special low rate was provided for vested remainders (4%) recognizing their unique nature. In 1975, Congress provided a floating rate on all unpaid taxes without considering the impact on vested remainders.

3. Overall Tax Burden

The overall tax burden on estates with vested remainders is the estate tax plus whatever deferral interest accrues. Sec. 6163 allows deferral until six months after the death of the income beneficiary since that may be the earliest funds are available to meet the burden.

III. Illustration of Hardship

The change made in 1975 can cause a huge increase in the interest burden. For example, consider a vested remainder in $1 million subject to a twenty-year deferral and subject to a 50% estate tax:

	Value of $1 Million Remainder for Estate Tax Purposes	50% Estate Tax	Annual Interest at 4%	Annual Interest at 10% Rate
3½% Discount Table Used Prior to 1975	$500,000	$250,000	$10,000	$25,000
Current 10% Discount Table	150,000	75,000	3,000	7,500

Because the estate tax remains constant after the initial computation, the fluctuation in deferral interest rates produces wild swings. This table shows that the combined interest and tax burden anticipated when the election was made to postpone the tax in 1966 was a tax of $250,000 and annual interest on the tax of $10,000 at 4%. The initial tax burden would only have been about $75,000 if the current 10% discount rate had been in use and the interest $7,500 at a 10% rate. In each case the discount rate and interest rate reflect the economic situation on the valuation date. However, when current law applies a rate of 10% to the tax of $250,000, we see the equivalent to a 33 1/3% rate on $75,000. This 33 1/3% rate is not a theoretical "worst case" -- it is actually happening in each of the estates.

IV. Corrective Action

1. What Congress did in the 1986 Act by changes in the way of computing interest on unpaid taxes was to aggravate a bad situation. However, the right rule to prevent undue hardships to estates with vested remainders is to use consistent rates for both valuation of the remainder and interest on the postponed tax. We request an amendment to relate the two rates.

2. The most glaring cases of hardship are when the remainder interest was the major part of the estate. Therefore, the amendment should be restricted to instances when the remainder interest is more than 50% of the adjusted gross estate. We do not propose extending the new rule to reversions because the same potential hardship does not exist.

3. The Amendment applies to all amounts of interest that were accrued but not payable as of the date of enactment of the 1986 Act. However, no recomputation of interest would be provided when the interest has been previously paid. That limitation removes any chance of a double benefit.

4. Future changes in interest rates may provide a potential windfall when the discount rate was high on the valuation date but there is a lower current interest rate. That possibility is removed by the amendment.

5. A technical consideration is that discount rates are generally only reset at long intervals, while the interest rates are reset each quarter. For this reason the Amendment covers situations in which the interest rate and discount rate are considerably apart at the outset. While this was not the situation with either of the estates for whom this is submitted, we believe it appropriate to cover the possibility.

We are certain that anticipated revenue loss would be very small. The text of the suggested Amendment is attached.

Attachment

Section 1511 of the Tax Reform Act of 1986 is amended by adding the following at the end thereof:

SEC. ___. RATE OF INTEREST ON POSTPONED ESTATE TAX ATTRIBUTABLE TO REMAINDER INTERESTS IN PROPERTY.

(a) IN GENERAL.--Section 6601 of the Internal Revenue Code of 1986 (relating to interest on underpayment, nonpayment, or extension of time for payment, of tax) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) RATE OF INTEREST ON ESTATE TAX POSTPONED UNDER SECTION 6163 WITH RESPECT TO REMAINDER INTERESTS.--

"(1) IN GENERAL.--If--

"(A) the time for payment of an amount of tax imposed by chapter 11 is postponed as provided in section 6163 with respect to any qualified remainder interest, and

"(B) the value of the qualified remainder interests included in determining the gross estate of the decedent exceeds 50 percent of the value of the adjusted gross estate, interest on the amount so postponed to the extent attributable to qualified remainder interests shall (in lieu of the annual rate provided by subsection (a)) be paid at the modified underpayment rate, compounded annually.

"(2) MODIFIED UNDERPAYMENT RATE.--For purposes of paragraph (1)--

"(A) IN GENERAL.--Except as otherwise provided in this paragraph, the term 'modified underpayment rate' means the underpayment rate modified (if any) as provided by subparagraph (B).

"(B) COORDINATION WITH DISCOUNT RATE USED FOR VALUATION PURPOSES.--

"(i) UNDERPAYMENT RATE IN EXCESS OF DISCOUNT RATE BY MORE THAN 1 PERCENTAGE POINT.--If the underpayment rate exceeds the discount rate by more than 1 percentage point, the term 'modified underpayment rate' means the percentage equal to the sum of the discount rate and 1 percentage point.

"(ii) DISCOUNT RATE IN EXCESS OF UNDERPAYMENT RATE BY MORE THAN 1 PERCENTAGE POINT.--If the discount rate exceeds the underpayment rate by more than 1 percentage point, the term 'modified underpayment rate' means the percentage equal to the discount rate minus 1 percentage point.

"(C) UNDERPAYMENT RATE; DISCOUNT RATE.--For purposes of this paragraph--

"(i) UNDERPAYMENT RATE.--The term 'underpayment rate' means the underpayment rate established by section 6621.

"(ii) DISCOUNT RATE.--The term 'discount rate' means the rate used to value a remainder interest in property for purposes of chapter 11.

"(iii) RATES DETERMINED AS OF DUE DATE FOR ESTATE TAX RETURN.--The underpayment rate and the discount rate used for purposes of this paragraph shall be such rates as in effect on the last date prescribed for filing the return of tax imposed by chapter 11 (determined without regard to extensions thereof).

"(3) OTHER DEFINITIONS.--For purposes of this subsection--

"(A) QUALIFIED REMAINDER INTEREST.--The term 'qualified remainder interest' means any remainder interest other than a reversionary interest.

"(B) ADJUSTED GROSS ESTATE.--The term 'adjusted gross estate' has the meaning given such term by section 6166(b)(6).

"(C) VALUE.--Value shall be value determined for purposes of chapter 11 (relating to estate tax)."

(b) EFFECTIVE DATE.--

(1) IN GENERAL.--The amendments made by this section shall apply to interest on taxes the payment of which is postponed until after October 21, 1986, under section 6163 of the Internal Revenue Code of 1986.

(2) EXCEPTION FOR INTEREST PAID.--The interest required to be paid with respect to an estate tax postponed under section 6163 of such Code after the application of the amendment made by this section shall not be less than the interest paid on or before October 21, 1986, with respect to the estate tax so postponed.

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September 4, 1987

FILE NO

DIRECT DIAL NO 804 788 8208

Mary M. Levontin, Esq.
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

H.R. 2636 - Technical Corrections Act of 1987

Dear Ms. Levontin:

It has come to my attention that a reference in the Internal Revenue Code of 1986 (the "Code") is in need of a technical correction that does not appear to be addressed in the Technical Corrections Act. Although this point may have been noted since H.R. 2636 was released, I wanted to bring it to your attention in the event it has been overlooked.

Code section 415(d)(1) refers to adjustments for cost-of-living increases similar to the procedures used to adjust primary insurance amounts under section 215(i)(2)(A) of the Social Security Act. Section 215(i)(2)(A) of the Social Security Act does not exist. Section 415(i)(2)(A) of the Social Security Act refers to the cost-of-living increases and would appear to be the correct reference.

Please let me know if you have any questions about this matter.

Sincerely,

Claire V. Grant

Claire V. Grant
Legal Assistant

4803G
cc: Harry J. Connoway, Esq.
Ms. Laura Wilcox
Ms. Mary McAuliffe
Mark S. Dray, Esq.
James T. Tilton, Esq.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify before you this morning. My appearance before the Committee today is to highlight my concern about a substantial inequity in the Tax Reform Act of 1986 ("1986 Act") that I believe should be corrected through an amendment to S. 1350. This inequity arises from the transition rules regarding the implementation of new discounting rules applicable to property and casualty insurance companies. These rules are referred to as the "fresh start rules."

The 1986 Act's fresh start rules treat otherwise identically situated property and casualty insurance companies differently, depending on whether or not a company previously discounted loss reserves as now mandated for everyone. Quite unfairly, a company that previously discounted reserves is disadvantaged by the fresh start rules in comparison to the company which is only now beginning to discount. Specifically, if two property/casualty insurers have identical reserve liabilities, but one previously discounted loss reserves on its annual statement and the other did not, the company that has been discounting will receive a substantially smaller fresh start than its competitor. The competitive concerns associated with this inequitable treatment are apparent. Attached to my statement is an illustration of the inequity and statutory language that would address it (Attachment A).

I believe that it is appropriate to address this problem in the technical corrections bill. The change that I am asking you to consider is not a new transition rule. It is an amendment to a transition rule contained in the '86 Act.

I am of course aware that revenue concerns represent a major factor in assessing technical corrections legislation. While I believe that the fairness aspects of this matter independently justify addressing the matter in S. 1350 without regard to revenue considerations, I also believe that the proposed amendment properly should be treated as having no revenue effect. The proposed amendment would conform the statute to the method of estimating the cost of the fresh start benefit at the time of the enactment of the 1986 Act. Attached to my statement is a memorandum which discusses this point in more detail (Attachment B).

I am informed that the analysis of the revenue cost of the proposed amendment set forth in the attached memorandum is consistent with the approach the Joint Committee on Taxation took in estimating a conceptually comparable provision included in S. 1350. Specifically, section 105 (a) (10) of S. 1350 indicates that post-1986 installment sales income attributable to pre-1987 sales of passive loss type activities will be treated as passive income for purposes of offsetting passive losses under section 469 of the IRC. This provision of S. 1350 specifically reverses the published position of the Internal Revenue Service on this matter. It is my understanding that the Joint Committee on Taxation has taken the position that section 105 (a) (10) of S. 1350 has no revenue effect because the change will conform the statute to the assumption under which the Joint Committee on Taxation originally estimated the revenue effect of the passive loss rules. I believe this situation is conceptually identical to the situation concerning the proposed amendment because the amendment would conform the statute to the assumptions under which the Joint Committee on Taxation originally estimated the revenue effect of the fresh start rules.

I very much appreciate the attention of the Committee to this important matter.

ATTACHMENT A

TAX REFORM ACT OF 1986
PROPERTY AND CASUALTY INSURANCE RESERVES:
FRESH START TRANSITIONAL RULES

Tax Reform Act of 1986 -- Sec. 1023. Section 1023 of the Act (section 846 of the Code), relating to the taxation of property and casualty insurance companies, requires these companies to discount their loss reserves for the first time. As a part of this provision, section 1023 (e) (3) provided a so-called "fresh start" rule. The purpose of the "fresh start" rule was to allow insurers to start the year 1987 on the new, discounted basis for their loss reserves without taking into account any differences between the old and new bases for purposes of determining their taxable income.

Problem. This fresh start rule determines the new base by applying the new tax reserve discount factor to the "undiscounted annual statement reserve."

Thus, this rule provides a different amount of "fresh start" depending solely upon whether or not a company has been discounting its reserves on its annual statement. In other words, two insurance companies with identical liabilities will receive a different fresh start benefit if one company has been discounting such reserves on its annual statement ("A/S"), and the other company has not. The company that has been discounting such reserves will receive a smaller fresh start amount than the other company. This result is inequitable.

Solution. This inequity could be substantially corrected by applying the tax reserve discount rate to the "annual statement reserve (line 2 below) rather than the "undiscounted annual statement reserve" (line 1 below). This approach would result in substantial equity between Company A and Company B.

Illustration.

		Company A	Company B
1.	Undiscounted A/S Reserve	100	100
2.	A/S Reserve	100	95 (disc.)
3.	Fresh Start Rule:		
	Old Basis (line 2)	100	95
	New Basis (line 1) x (.93, assumed tax discount rate)	93	93
	Fresh Start Amount	7	2
4.	Proposed Fresh Start Rule:		
	Old Basis (line 2)	100	95
	New Basis (line 2 x .93)	93	88.35
	Fresh Start Amount	7	6.65

Statutory Draft

This proposed fresh start transition rule might be implemented by amending section 1023 of the Tax Reform Act of 1986 as follows:

SEC. ____ . AMENDMENT RELATED TO SECTION 1023 OF THE ACT.

Paragraph (2) of section 1023 (e) of the Tax Reform Act of 1986 (relating to transition rules) is amended by adding at the end thereof the following new sentence:

"For purposes of the first sentence of this paragraph, unpaid losses with respect to workers' compensation shall be determined without application of paragraph (2) of section 846 (b) of such Code (as added by this section) where such unpaid losses were shown on the annual statement on a discounted basis."

ATTACHMENT B

MEMORANDUM

ANALYSIS OF PROPER ESTIMATING CONVENTION FOR TRANSITION RULE INTENDED TO CONFORM FRESH START BENEFIT FOR PRE-1986 DISCOUNTED RESERVES

I. Background

The Tax Reform Act of 1986 ("1986 Act") for the first time requires property and casualty insurance companies to discount unpaid losses and certain unpaid expenses. Section 1023 of the 1986 Act and section 846 of the IRC. This provision is generally applicable to taxable years after December 31, 1986. Section 1023(e)(1). Application of the discounting provisions to existing reserves is governed by section 1023(e)(2). It provides that opening reserves on January 1, 1987, are to be calculated as if the discounting provisions of the 1986 Act originally had been applicable to the losses and expenses related to these reserves. The provision is similar to a comparable provision provided in the Deficit Reduction Act of 1984 related to a modification of the reserve deductions allowed for life insurance companies. The effect of this provision is to provide a double deduction of the amount equal to the difference between undiscounted expenses and losses and the discounted expenses and losses (the "fresh start benefit"). Under section 1023(e)(3), the fresh start benefit is not to be taken into account for purposes of the Internal Revenue Code of 1986. The fresh start benefit for a property and casualty insurance company generally is equal to the difference between the undiscounted reserves and the discounted reserves. For example, if a company had an undiscounted reserve of $100 on December 31, 1986, effective January 1, 1987, such reserve would be restated as if it had been discounted originally, i.e., at $93. In this case, the amount of the fresh start benefit is $7.

Prior to the 1986 Act, almost all property and casualty companies did not discount unpaid losses or unpaid expenses. A small minority of companies already had begun discounting of such reserves prior to the 1986 Act. For those companies, the application of the fresh start rules will provide a smaller benefit than for those companies that had not been discounting reserves. For example, if in the example discussed above the company had discounted its $100 reserve to $95 prior to the 1986 Act, the amount of the fresh start benefit would only be $2 (i.e., the difference between $93 and $95).

II. Proposed Conforming Transition Rule

The operation of the fresh start rule under section 1023(e) unfairly discriminates in favor of those companies that had not discounted reserves prior to the 1986 Act while penalizing companies that already had been discounting reserves. It is suggested that a proper method of addressing this discriminatory aspect is to provide a conforming transition rule which would provide companies that had been discounting reserves prior to the 1986 Act with treatment comparable to that of companies that had not discounted reserves.

III. Proper Estimating Convention for Transition Rule to Conform Fresh Start Benefit.

A. Overview.

In considering the proposed transition rule, a relevant factor will be, what, if any revenue effect should be attributable to it. The purpose of this memo is to suggest that the transition rule proposed should be treated as having no revenue effect. There are two possible ways in which the fresh start benefit originally could have been estimated. Under either approach, it is believed that the inclusion of the proposed transition rule would not have affected the revenue estimate and, therefore, should be treated as having no revenue effect if implemented as part of technical correction legislation. The two possible methods of originally estimating the fresh start provision are discussed below along with the basis for concluding that the proposed transition rule should be viewed as having no revenue effect as part of technical corrections legislation.

B. Estimate of Transition Rule Assuming that the Fresh Start Benefit was not Originally Taken Into Account in Computing Discounting Provisions.

It is possible that the estimate of the discounting provisions of the 1986 Act did not take into account the fresh start aspect of these rules. No publicly released documents indicate that the fresh start benefit was taken into account. If this is the case, the inclusion of the proposed technical correction transition rule would have had no impact on the estimate of the impact of the discounting provisions nor would it have had an impact on the overall estimate of the provisions affecting the property and casualty industry. If this is the case, inclusion of the technical correction transition rule as part of the technical corrections process also should be viewed as having no revenue effect.

C. Effect of Proposed Transition Rule Assuming that the Fresh Start Provisions were Taken into Account in Estimating the Discounting Provision.

In the alternative, the method used to estimate the discounting provisions may have assumed some loss of revenue attributable to the fresh start benefit. Given the small minority of companies which were actually discounting reserves prior to the 1986 Act, however, it is unlikely that any assumption was made as to the effect which the discounting of those reserves prior to the 1986 Act had on the effect of the fresh start benefit. That is, it is assumed that the fresh start benefit was calculated assuming that no companies were discounting reserves prior to the 1986 Act. As a consequence, the inclusion of the proposed technical transition rule to provide all companies with the same fresh start benefit without regard to whether they were discounting reserves prior to the 1986 Act would have had no impact on the validity of the initial revenue estimate. As a result, the inclusion of the proposed technical transition rule as part of the technical corrections legislation also should be viewed as having no revenue impact.

STATEMENT OF SENATOR GORDON J. HUMPHREY ON S.1350, THE TECHNICAL CORRECTIONS ACT OF 1987

ADOPTION EXPENSES TRANSITION PERIOD SHOULD BE INCLUDED IN THE TECHNICAL CORRECTIONS BILL

MR. CHAIRMAN, ONE OF THE GREAT ACCOMPLISHMENTS OF THE 99TH CONGRESS WAS THE TAX REFORM BILL. I STRONGLY SUPPORTED TAX REFORM. HOWEVER, I HAVE SERIOUS CONCERNS ABOUT ONE PROVISION WHICH, IF NOT ADDRESSED, WILL ADVERSELY AFFECT ADOPTIVE PARENTS AND THE MOVEMENT OF CHILDREN OUT OF THE FOSTER CARE SYSTEM AND INTO PERMANENT HOMES.

ACCORDING TO THE DEPARTMENT OF HEALTH AND HUMAN SERIVCES, AN ESTIMATED 276,000 CHILDREN ARE IN FOSTER CARE, AT LEAST 36,000 OF WHOM ARE LEGALLY FREE AND WAITING FOR ADOPTIVE HOMES. MANY ARE CHILDREN WITH SPECIAL NEEDS, THAT IS, CHILDREN WHO ARE OLDER, IN SIBLING GROUPS, PHYSICALLY OR EMOTIONALLY DISABLED, OR MEMBERS OF MINORITY GROUPS.

CONGRESS HAS RECOGNIZED THE NEED TO ENCOURAGE AND REDUCE THE FINANCIAL BURDEN ASSOCIATED WITH THE ADOPTION OF CHILDREN WITH SPECIAL NEEDS. UNTIL JANUARY OF THIS YEAR, THAT WAS ACCOMPLISHED, IN PART, THROUGH A MODEST $1500 TAX DEDUCTION. THE TAX REFORM ACT OF 1986 REPEALED THIS DEDUCTION AND REPLACED IT WITH A NEW ENTITLEMENT PROGRAM UNDER TITLE IV-E OF THE SOCIAL SECURITY ACT, WHICH WOULD ALLOW STATES TO REIMBURSE DIRECTLY FAMILIES WHO ADOPT THESE CHILDREN FOR SOME OR ALL OF THEIR EXPENSES.

UNFORTUNATELY, WHILE ADOPTIVE PARENTS HAVE LOST THE TAX DEDUCTION, THE NEW REIMBURSEMENT SYSTEM IS A LONG WAY FROM BEING IN PLACE. IT IS NOT CLEAR WHEN HHS WILL PROMULGATE THE FINAL REGULATIONS. UNFORTUNATELY, THE TAX REFORM ACT CONTAINED NO PROVISION FOR A TRANSITIONAL PERIOD TO ALLOW THE FEDERAL GOVERNMENT, STATE TITLE IV-E ADOPTION AGENCIES, AND PRIVATE ADOPTION AGENCIES TIME TO WORK OUT PROCEDURES TO IMPLEMENT THE DIRECT PAY SYSTEM.

THE DELAYS IN IMPLEMENTING THIS PROGRAM MIGHT PREVENT ELIGIBLE PARENTS FROM RECEIVING THE BENEFITS THEY NEED IN A TIMELY FASHION, AND THUS DISCOURAGE ADOPTION. I FEEL WE NEED TO AVOID THIS. ON THE FIRST DAY OF THIS CONGRESS, I INTRODUCED S. 270, TO PROVIDE FOR A TRANSITION PERIOD FOR THE DIRECT REIMBURSEMENT PROGRAM. THIS MEASURE READS SIMPLY:

"THE AMENDMENTS MADE BY SECTION 135 SHALL APPLY TO TAXABLE YEARS BEGINNING AFTER DECEMBER 31 OF THE CALENDAR YEAR IN WHICH FINAL REGULATIONS ARE ISSUED TO IMPLEMENT THE REIMBURSEMENT OF NONRECURRING ADOPTION EXPENSES UNDER ANY ADOPTION ASSISTANCE AGREEMENT UNDER SUBTITLE E OF THE TITLE IV OF THE SOCIAL SECURITY ACT.

NO DEDUCTION SHALL BE ALLOWED WITH RESPECT TO AMOUNTS PAID FOR ADOPTION EXPENSES DIRECTLY RELATED TO THE LEGAL ADOPTION OF A CHILD WITH SPECIAL NEEDS UNDER SECTION 222 OF THE INTERNAL REVENUE CODE OF 1986 TO ANY TAXPAYER RECEIVING REIMBURSEMENT FOR SUCH AMOUNTS UNDER ANY ADOPTION ASSISTANCE AGREEMENT UNDER SUBTITLE E OF TITLE IV OF THE SOCIAL SECURITY ACT."

THE ADOPTIVE PARENTS ENTITLED TO THIS REIMBURSEMENT ARE THE INDIVIDUALS AND COUPLES WHO GIVE PERMANENT HOMES TO CHILDREN WHO NEED IT THE MOST. THEY ARE PEOPLE WHO ARE WILLING TO TAKE ON LARGE RESPONSIBILITIES IN ORDER TO BUILD A FAMILY AND BRING JOY TO A CHILD WHO NEEDS A HOME.

MR. CHAIRMAN, I URGE YOU AND THE COMMITTEE TO ASSIST SPECIAL NEEDS ADOPTIONS BY ADDING THE TEXT OF S. 270 TO S. 1350.

GEORGE J. MITCHELL
MAINE

United States Senate
WASHINGTON, DC 20510

May 22, 1987

Senator Lloyd Bentsen
Chairman
Senate Finance Committee
205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Lloyd:

I am writing to again express my support for further modifications in the language of the Technical Corrections bill that would enable Georgetown University to issue tax exempt bonds.

For several years, Georgetown University has attempted to have tax exempt bonds issued on its behalf through the District of Columbia. The issuance of these bonds have been held up indefinitely by an unrelated suit before the D.C. Court of Appeals.

Because Georgetown had made plans based on prior law, Congress included a transition rule in the Tax Reform Act of 1986, allowing the university to rely on prior law with respect to the treatment of the tax exempt bonds. Although this rule was included in the tax reform bill, a clarification was provided in the concurrent resolution accompanying the tax bill to permit Georgetown greater latitude in having the bonds issued. Unfortunately, a further modification to the transition rule is now necessary because, in spite of Congressional intent to the contrary, it appears that Georgetown will be indefinitely foreclosed from having the bonds issued on their behalf.

I believe this is a reasonable request and consistent with the ground rules you have established for the Technical Corrections legislation. Congress intended in the tax reform bill to permit up to $200 million of bonds to be issued for Georgetown University. The cost of these bonds was calculated in the revenue estimates of the bill and the requested modification would only serve to enable Georgetown to do what Congress had originally proposed. It is necessary that the technical amendment permit the university to serve as the issuer of the bonds. While I realize this is unusual, I understand it to be consistent with other transition rules in the Tax Reform Act which permit certain state-related private universities to issue tax exempt bonds.

Thank you for your attention to my request.

With best regards,

Sincerely,

George Mitchell

George J. Mitchell
United States Senator

II

100TH CONGRESS
1ST SESSION

S. 270

To provide a transition period for the full implementation of the nonrecurring adoption expenses reimbursement program.

IN THE SENATE OF THE UNITED STATES

JANUARY 6, 1987

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

A BILL

To provide a transition period for the full implementation of the nonrecurring adoption expenses reimbursement program.

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

SECTION 1. TRANSITION PERIOD FOR FULL IMPLEMENTATION OF NONRECURRING ADOPTION EXPENSES REIMBURSEMENT PROGRAM.

(a) IN GENERAL.—Section 151 of the Tax Reform Act of 1986 (relating to effective dates) is amended by adding at the end thereof the following new subsection:

"(f) ADOPTION EXPENSES.—

"(1) IN GENERAL.—The amendments made by section 135 shall apply to taxable years beginning after December 31 of the calendar year in which final regulations are issued to implement the reimbursement of nonrecurring adoption expenses under any adoption assistance agreement under subtitle E of title IV of the Social Security Act.

"(2) DENIAL OF DOUBLE BENEFIT.—No deduction shall be allowed with respect to amounts paid for adoption expenses directly related to the legal adoption of a child with special needs under section 222 of the Internal Revenue Code of 1986 to any taxpayer receiving reimbursement for such amounts under any adoption assistance agreement under subtitle E of title IV of the Social Security Act.".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect as if included in section 151 of the Tax Reform Act of 1986.

O

United States Senate

COMMITTEE ON FINANCE
WASHINGTON, DC 20510

May 28, 1987

The Honorable George J. Mitchell
United States Senate
Washington, D.C. 20510

Dear George:

Thank you for your letter regarding the transition rule Georgetown University received in the 1986 Tax Reform Act.

I understand that Georgetown has been unable to issue tax exempt bonds under the transition rule because of a legal dispute in the District of Columbia. It is unfortunate that a six-year old court case is delaying the issuance of Georgetown's bonds.

As you know, Dan Rostenkowski and I have been working for the past few months putting together a technical corrections bill. We hope to be able to introduce that bill in the next few weeks. From the outset, Dan and I agreed to keep the bill free from substantive amendments in order to minimize the chances for delay in enacting these important corrections.

The Georgetown issue has been seriously discussed on a number of occasions in the preparation of that bill. Unfortunately, under the very strict definition of technical correction which we have utilized in sifting through the myriad requests, it does not appear that the change requested by Georgetown will qualify. Nevertheless, this is certainly an issue that can be discussed in the Finance Committee when we meet to consider technical corrections.

Thank you again for bringing this matter to my attention. I will keep your concerns in mind as we consider this issue again in the future.

Sincerely,

Lloyd Bentsen

WILLIAM V. ROTH, JR.
DELAWARE

104 HART SENATE OFFICE BUILDING
TELEPHONE 202-224-2441

COMMITTEES:
GOVERNMENTAL AFFAIRS
FINANCE
JOINT ECONOMIC COMMITTEE
SELECT COMMITTEE ON INTELLIGENCE

United States Senate

WASHINGTON, DC 20510

June 13, 1987

The Honorable Bob Packwood
United States Senate
Washington, D.C. 20510

Dear Bob:

It is my understanding that Senator Mitchell may offer an amendment when we consider the Technical Corrections bill which would enable Georgetown University to issue tax exempt bonds.

For several years, Georgetown University has attempted to have tax exempt bonds issued on its behalf through the District of Columbia. The issuance of these bonds have been held up indefinitely by an unrelated suit before the D.C. Court of Appeals.

You may recall that last year in recognition of the unique problems facing Georgetown University transition relief was provided to permit up to $200 million of bonds to be issued. Senator Mitchell's amendment which would provide issuing authority to the University is necessary to allow Georgetown to proceed.

I hope we will be able to resolve this problem during Committee consideration.

Sincerely,

Bill

William V. Roth, Jr.
United States Senate

WVR/aca

STATEMENT BY SENATOR MURKOWSKI FOR THE JULY 22, 1987 SENATE FINANCE COMMITTEE HEARING ON THE TECHNICAL CORRECTIONS TAX BILL TO THE TAX REFORM ACT OF '86.

LAST-SESSION, IN RECOGNITION OF THE NEED FOR GREATER TAX EQUITY, WE REMOVED MILLIONS OF LOW-INCOME PEOPLE FROM THE TAX ROLLS WHEN WE PASSED THE TAX REFORM ACT OF '86. THAT WAS ONE OF THE PRIMARY REASONS WHY I SUPPORTED TAX REFORM.

I NOW FIND THAT THE COMBINED EFFECT OF SEVERAL CHANGES IN THE TAX REFORM ACT WILL SUBJECT OVER 1/4 OF ALASKA'S POPULATION, ALL OF THEM CHILDREN UNDER THE AGE OF 14, TO A NEW TAX AND FILING REQUIREMENT, EVEN THOUGH NEARLY ALL OF THEM ARE OF LOW-INCOME. I BELIEVE THAT THIS EFFECT WAS UNINTENDED, AND I ASK FOR YOUR SUPPORT FOR AN AMENDMENT TO CORRECT THIS.

THE TAX REFORM ACT REQUIRES CHILDREN UNDER THE AGE OF 14 TO FILE A RETURN AND PAY A TAX ON UNEARNED INCOME OF MORE THAN $500, IF THEY ARE CLAIMED AS A DEPENDENT ON ANOTHER'S TAX RETURN. UNLIKE IN THE PAST, THOSE CHILDREN NO LONGER MAY OFFSET THE TAX ON THAT INCOME DUE TO THE LOSS OF THE FULL USE OF THE STANDARD DEDUCTION, ITEMIZED DEDUCTIONS, AND PERSONAL EXEMPTION.

EACH YEAR ALASKA CHILDREN ARE ENTITLED TO RECEIVE AN ALASKA PERMANENT FUND DIVIDEND FROM THE ALASKA PERMANENT FUND. THE ALASKA PERMANENT FUND IS A STATE ROYALTY OIL TRUST SET UP IN 1976 TO PROVIDE FOR ALASKA'S FUTURE. THE AMOUNT OF THE DIVIDEND VARIES FROM YEAR TO YEAR DEPENDING ON THE FUND'S EARNINGS. LAST YEAR 129,455 CHILDREN UNDER THE AGE OF 14 RECEIVED A DIVIDEND OF $556. THIS YEAR, IT IS EXPECTED TO BE ROUGHLY $700.

THE DIVIDEND IS CONSIDERED "UNEARNED INCOME" FOR TAX PURPOSES. THIS YEAR UNDER THE NEW TAX ACT, ALASKA CHILDREN WHO HAVE NO INCOME OTHER THAN AN ALASKA PERMANENT FUND DIVIDEND WILL HAVE TO FILE AND PAY A TAX OF ROUGHLY $22.00.

NOT ONLY DOES THIS PLACE AN UNNECESSARY BURDEN ON CHILDREN, BUT IT IS HIGHLY LKELY THAT THE COSTS INCURRED IN COLLECTION MAY EXCEED THE REVENUE COLLECTED!

MY REQUEST IS SIMILAR TO ANOTHER PROBLEM CORRECTED BY CONGRESS AT MY REQUEST IN 1982 WHEN IT RAISED THE DOLLAR THRESHOLD AMOUNT TRIGGERING THE FILING OF A TAX RETURN OF A DEPENDENT TO $1001. THIS WAS DONE IN RECOGNITON OF THE UNIQUE TAX CONSEQUENCES OF THE ALASKA PERMANENT FUND DIVIDEND.

FINALLY, I MIGHT ADD THAT THE EFFECT OF THE TAX ACT'S CHANGES, AS UNINTENDED AS IT MAY HAVE BEEN IN THIS CASE, IS ALSO NOT IN KEEPING WITH ONE OF THE PURPOSES FOR THOSE CHANGES -- TO PREVENT THE TAX SHELTERING OF INCOME THROUGH THE SHIFTING OF INCOME FROM A PARENT TO A CHILD IN A LOWER TAX BRACKET. THE DIVIDEND FALLS OUTSIDE THE CONTEXT OF INCOME SHIFTING. IT IS A STATE BENEFIT GIVEN DIRECTLY TO A CHILD THAT IS NOT PART OF A FAMILY TAX PLANNING SCHEME.

BECAUSE OF THESE REASONS, I ASK THE COMMITTEE ACCEPT MY AMENDMENT TO ALLOW DEPENDENT CHILDREN UNDER THE AGE OF 14 WHO DO NOT ITEMIZE DEDUCTIONS TO INCREASE THEIR LIMITED $500 STANDARD DEDUCTION BY THE AMOUNT OF THEIR ALASKA PERMANENT FUND DIVIDEND.

MY AMENDMENT IS LIMITED TO ONLY THOSE CHILDREN WITH LITTLE OR NO INCOME OTHER THAN AN ALASKA PERMANENT FUND DIVIDEND. I BELIEVE THAT IT IS A MODEST REQUEST IN RELATION TO THE DISPROPORTIONATE BURDEN ON ALASKA'S CHILDREN. THE JOINT TAX COMMITTEE ESTIMATES A REVENUE LOSS OF ONLY $1 MILLION FOR FY '88. BUT, IT MAY VERY WELL BE "REVENUE-NEUTRAL" IF ONE DEDUCTS ENFORCEMENT COSTS.

I THANK THE COMMITTEE FOR ITS CONSIDERATON ON THIS AND OFFER TO YOU WHATEVER ASSISTANCE THAT MAY BE NEEDED.

Ætna

Financial Division
CityPlace
Hartford, CT 06156

Francis X. Smith
Vice President
Taxes and Accounting Policy
(203) 275-2876

July 20, 1987

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate
Committee on Finance
Room SD-205
Dirksen Senate Office Building
Washington, D.C. 20510

RE: COMMENTS ON TECHNICAL CORRECTIONS BILL
TRANSITION RULE FOR MARKET DISCOUNT BONDS

Dear Ms. Wilcox:

Section 110 of H.R. 2636 provides that capital gains on "market discount bonds" held by certain life insurance companies will be taxed at a rate of 31.6%. Section 110 "corrects" the 1986 Tax Reform Act, making two changes in the transition rule provided by that Act: (1) coverage is expanded from the original 15 companies to all life insurance companies, and (2) the tax rate is increased from 28% to 31.6%.

Ætna supports the written comments submitted by the American Council of Life Insurance in urging a generic 29.1% rate. Simply put, the cost of a 29.1% generic rate equals the cost of the original 15 company transition rule. Therefore, changing the tax rate to 29.1% (instead of 31.6%) will not change the government's budget, as reflected in the February baseline.

For Ætna, Section 110's rate increase from 28% to 31.6% represents a significant cost. The company has relied on prior Congressional policy, first established in the 1984 Act, to grant transitional tax relief for market discount bonds. Investment returns from these bonds are reflected in the interest rates that Ætna has guaranteed to its customers. The company cannot now recover from these customers any increase in the tax costs of these bonds.

While a 29.1% rate does not fully restore the relief provided by the original transitional rule, the ACLI proposal is equitable and provides much of the original, intended relief. Accordingly, the Committee should adopt the proposal.

Sincerely,

F X Smith

Francis X. Smith
Vice President
Taxes and Accounting Policy

/jch

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

1101 SIXTEENTH STREET, N.W.
WASHINGTON, D.C. 20036
(202) 857-4722

CRAIG G. GOODMAN
SENIOR COUNSEL AND
DIRECTOR OF ENERGY AND TAX POLICY
(202) 857-4731

June 30, 1987

Ms. Laura Wilcox
Hearing Administrator
Room SD-205
United States Senate
Washington, D.C. 20510

Dear Ms. Wilcox:

I have set forth below for your consideration three recommendations for technical correction to the Tax Reform Act of 1986. IPAA and its members would greatly appreciate any consideration you might give to these proposals.

ITEM I
Elimination of the Unintended
Penalty Against Oil and Gas Producers Which Occurs
as a Result of New IRC Section 163(d)(5)(A)(ii)

Section 469 of the Tax Reform Act of 1986 limits a taxpayer's ability to deduct losses from a "passive activity" against any income other than passive income. A "passive activity" is defined as the conduct of a trade or business in which the taxpayer does not "materially participate". However, because of the "severe hardship due to the worldwide collapse in oil and gas prices," the Congress excluded from the operation of the passive loss rules, owners of working interests in oil and natural gas properties where liability is not limited by reason of the form of such ownership. Congress specifically intended that losses attributable to the ownership of such working interests be fully deductible against other forms of "active income". Interest expense, would normally be a component of such losses. However, IRC Section 163(d)(5)(A)(ii) appears to conflict with the new passive loss rules and imposes another "material participation" standard which determines separately the deductibility of follow that these same expenses also were intended to be included within the working interest exception to these rules.

New Section 163(d)(5)(A)(ii) acts as a penalty which specifically targets operators and investors in oil and natural gas activities at a time when Congress specifically intended to grant the industry a limited form of relief. IPAA urges Congress to clarify, as a technical correction, that interest expenses attributable to working interests in oil and natural gas properties are fully deductible when computing losses under the working interest exception to the passive loss rules.

RECOMMENDED TECHNICAL CORRECTION

We recommend that Section 163(d)(5)(A)(ii) IRC be deleted.

ITEM 2

Exemption From Overhead and Interest Capitalization Rules

Section 803 of the Tax Reform Act of 1986 requires capitalization, and inclusion in inventory, costs of certain expenses. It is unclear whether "property produced by a taxpayer" should include the "construction" (drilling) of an oil or gas well under IRC Section 263A(b)(1). However, if IRS takes the position that an oil or gas well is a "self-constructed asset", overhead and interest expenses allocable to drilling a well may be subject to capitalization. It should be noted that Section 263A(c)(3) provides an exception from this capitalization requirement for any cost allowable as a deduction under Section 263(c), intangible drilling and development costs.

In the face of strong industry opposition, the IRS has argued for the last several years that indirect costs and overhead should be allocated to a taxpayer's IDC costs, and therefore treated like IDCs. If this position is correct, it would follow that under new Section 263A, any overhead interest expense for owners of working interests in oil and natural gas properties.

IPAA maintains that there should not be two separate "material participation" standards for computing losses attributable to owners of working interests in oil and gas properties. If a working interest owner qualifies for the exclusion from the passive loss rules under new Section 469(c)(3), that exclusion should apply to all expenditures, including interest expenses, associated with that working interest.

The Senate-passed version of the passive loss rules is the definitive legislative history on the Congressional intent behind the "material participation" standard. In the Senate Finance Committee Report, it plainly states on page 717 that the Committee believes "...that financial risks or other factors rather than material participation should be the relevant standard" for the oil and natural gas industry. Direct working-interest owners in oil and natural gas specifically were excluded from the material participation standard because relief from the worldwide collapse of oil prices "requires that tax benefits be provided to attract outside investors". However, as written, new IRC Section 163(d)(5)(A)(ii) actually could penalize outside investors in oil and gas activities. This occurs because the second "material participation" standard will, in effect, work to limit not only interest expenses associated with the working interest, but also any other investment interest expenses the investor may have as well.

In further support of this position, Section 501 of the new Act specifically includes interest expense as a component of any loss that is computed under the new passive loss rules. The conference agreement reads, in part, as follows:

> "The passive loss rule applies to all deductions that are from passive activities including deductions allowed under sections 162, 163, 164, and 165."

IPAA maintains that if deductions under section 163 (interest expense) are intended to be included within the passive loss rules, it should costs that are attributable to the "construction" of an oil or natural gas well should be exempt from this rule under Section 263A(c)(3).

Sometimes as much as 80 percent of the cost to drill an oil or gas well is IDC, deductible under Section 263(c). Therefore, using IRS logic, as much as 80 percent of the allocated overhead costs under Section 263A should be exempt from this rule. It would be impractical to capitalize and depreciate or deplete the small amount of overhead that is not treated in the same manner as IDC's by the IRS.

IPAA therefore recommends that oil and natural gas drilling be exempted from this new rule. The costs of compliance would be overly burdensome, and the revenue impact on the Treasury should be minimal.

RECOMMENDED TECHNICAL CORRECTION

We recommend that IRC Section 263A(c)(3) be amended to read as follows:

> "(3) CERTAIN DEVELOPMENT AND OTHER COSTS OF OIL AND GAS WELLS OR OTHER MINERAL PROPERTY. This section shall not apply to the drilling of oil and gas wells or geothermal wells nor will it apply to any cost allowable as a deduction under Section 616(a) or 617(a)."

ITEM 3

Elimination of the Double Tax Detriment In Determining Items of Tax Preference

Section 57(a)(1) generally provides that the excess of percentage depletion over the adjusted basis of the property at the end of the year is an item of tax preference. Section 57(a)(2) generally provides that the amount (if any) by which the amount of excess IDC is greater than 65 percent of the "net income from oil and natural gas" is also an item of tax preference. However, in determining "net income from oil and natural gas", gross income must be offset by the "amount of any deductions" allocable to the property [See: Section 57(a)(2)(C)(ii)]. Since one tax preference item ("excess" percentage depletion) is used to compute another tax preference item ("excess" IDC's) taxpayers are inequitably penalized by "double counting" items of tax preference when computing alternative minimum tax liability.

RECOMMENDED TECHNICAL CORRECTION

We recommend the following statutory change to Section 59(g):

1. Change the title of Section 59(g) to:
   "SPECIAL RULES IN DETERMINING ITEMS OF TAX PREFERENCE".
2. Redesignate Section 59(g) as Section 59(g)(1).
3. Add new Section 59(g)(2), as follows:
   "(2) NO DOUBLE COUNTING OF PREFERENCES. - For purposes of this part, each tax preference is determined without regard to any other tax preference."

After you have a chance to review this material please give me a call so that Mark Edmunds and I can stop by to discuss these issues with you further. Thank you again for your time and consideration.

Very truly yours,

Craig G. Goodman

CGG/se

July 15, 1987

IPC

Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

RE: Finance Committee Requests for Public Comment on S.1350 Technical Corrections Act of 1987

Dear Ms. Wilcox:

In accordance with Finance Committee Press Release #G-3 dated 17 June 1987, we are respectfully submitting comment on an apparent oversight concerning Act Section 1107 of TRA '86 and Section 457 of the Internal Revenue Code.

Act Section 1107 of TRA '86 extended for the first time unfunded deferred compensation plans described in IRC §457 to employees of nongovernmental tax-exempt organizations on supposedly the same basis as they are made available to employees of State and local governments. Nongovernmental tax-exempt organizations are defined at IRC §§501(c) and 501(d), and in total consist of some 25 different types of organizations ranging from credit unions to labor organizations.

However, the Department of Labor, in a release dated December 19, 1986, has indicated such is not the case (see U.S. Dept. of Labor News Release dated 19 December 1986 enclosed). In this Release, the Department of Labor has taken the position that plans described in IRC §457 maintained by nongovernmental tax-exempt organizations are only available for a "select group of management or highly compensated employees". This position is based on the premise that no Act Section exists under ERISA whereby plans maintained by nongovernmental tax-exempt organizations are excluded from the requirements of Title I of ERISA.

This position was further confirmed in a telephone conversation with Department of Labor representative, Linda Shore, 7 July 1984. As stated by her, Congressional action must be taken to specifically exclude IRC §457 plans maintained by nongovernmental tax-exempt organizations from the requirements of Title I of ERISA before such plans would be permissible. As indicated by her, such an exclusion does exist for governmental plans under §3(32) of Title I of ERISA; therefore, IRC §457 plans maintained by State or local governments can be offered to all employees in general and is not limited to only a "select group of management or highly compensated employees".

IPC

In the locale that we serve, we have numerous credit unions, labor organizations, etc., that are poised to offer such plans to all of their employees, but are now stymied by what appears to be conflicting positions being maintained by two branches of the government. Treasury, on the one hand stating it is permissible for nongovernmental tax-exempt organizations to sponsor IRC §457 plans; and Labor, on the other hand, stating not so until a specific exclusion is provided from Title I requirements of ERISA.

Therefore, we respectfully request that immediate attention be given to this area in the Technical Corrections Act as it pertains to Act §1107 of TRA '86. To deny nongovernmental tax-exempt organizations to maintain such plans simply because of a conflict between two regulatory agencies of the government would be a travesty; especially so, since TRA '86 now prohibits these same nongovernmental tax-exempt organizations from maintaining 401(k) plans.

Should you have any further questions concerning these comments, please contact the undersigned, or Gerry Tornow of my staff. Should you wish to contact Linda Shore of the Department of Labor, she may be reached at phone number 202-5232-8672.

Sincerely,

Jeffrey N. Cashman, President
IPC Pension Companies, Inc.

GAT/jh

cc: Senator Daniel J. Evans
Senator Brock Adams
Congressman Rod Chandler
Congressman John Miller

SUMMARY STATEMENT

UNFUNDED DEFERRED COMPENSATION ARRANGEMENTS OF STATE AND LOCAL GOVERNMENTS AND TAX EXEMPT EMPLOYERS.
(Section 111(e) of the TCA '87 bill, Section 1107 of the Reform Act, and Section 457 of the Internal Revenue Code)

(a) Application to tax-exempt employers: ERISA Coverage

Present Law

State and local governments are permitted under Section 457 of the Internal Revenue Code to maintain eligible unfunded deferred compensation plans. Amounts of current compensation deferred on behalf of participants under these plans are excluded from their gross income until such time as the funds are paid or made available to them. Because Congress determined that unfunded deferred compensation plans should be available to employees of nongovernmental tax-exempt organizations on the same basis as they are made available to employees of the State and local governments, Act Section 1107 was enacted effective for taxable years beginning after 31 December, 1986. The Act applies the limitations and restrictions applicable to eligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations.

Accordingly, these plans need not satisfy any of the requirements of Internal Revenue Code Section 401(a); but must satisfy all of the requirements of Internal Revenue Code Section 457.

However, Title I of ERISA, which mirrors many of the provisions of Internal Revenue Code Section 401(a), is applicable to unfunded deferred compensation plans. As such, certain participation and vesting, funding, and fiduciary responsibility provisions are applicable to Section 457 plans sponsored by nongovernmental tax-exempt organizations, unlike State and local government sponsored Section 457 plans, which have a specific statutory exclusion from the requirements of Title I of ERISA.

Reason for Technical Correction Change

In the absence of a specific ERISA exclusions, Section 457 plans sponsored by nongovernmental tax-exempt organizations would be required to satisfy Title I or ERISA; and in so doing would fail to satisfy Internal Revenue Code Section 457 requirements.

Action Needed to Correct

A specific ERISA exclusion must be granted to nongovernmental tax-exempt organizations sponsoring Section 457 plans identical to the exclusions currently granted to State and local governments which sponsor this same type of plan.

LABOR DEPARTMENT ISSUES VIEWS ON ERISA COVERAGE OF TAX-EXEMPT ORGANIZATIONS

DOL News Release (USDL: 86-527). December 19, 1986.

Tax-exempt organizations: Unfunded deferred compensation plans: ERISA coverage. —Unfunded deferred compensation plans established by tax-exempt organizations under Code Sec. 457 following the Tax Reform Act of 1986 are not exempt from ERISA Title I provisions concerning vesting, funding and fiduciary responsibility.

Certain employee benefit plans established by tax-exempt organizations following recent tax law changes ordinarily would be covered by the Employee Retirement Income Security Act (ERISA), the Labor Department warned today.

The department's Pension and Welfare Benefits Administration said it was referring to unfunded deferred compensation plans established by tax-exempt organizations under Section 457 of the Internal Revenue Code as amended by the Tax Reform Act of 1986.

Such plans ordinarily would be subject to the requirements of title I of ERISA, the Labor Department said.

State and local governments are permitted under the code to maintain eligible unfunded deferred compensation plans. Amounts of current compensation deferred on behalf of participants under these plans are excluded from their gross income until such time as the funds are paid or made available to them.

Under the Tax Reform Act of 1986, this treatment was extended to unfunded deferred compensation plans of other tax-exempt organizations.

In the absence of specific ERISA exclusions, unfunded deferred compensation plans would generally be considered pension plans subject to certain participation and vesting, funding, and fiduciary responsibility provisions of title I of ERISA.

However, ERISA excludes from the requirements of title I any employee benefit plan which is defined as a governmental plan under section 3(32) of title I. However, such exclusion does not extend to plans maintained by tax-exempt organizations.

The Labor Department said it is concerned that the employee benefit plan community may be broadly interpreting the 1986 amendment of section 457 of the code as excluding the unfunded deferred compensation plans of tax-exempt organizations from title I coverage.

Consequently, the department is expressing its view that unfunded plans maintained by entities which are not statutorily exempt from title I of ERISA are subject to all applicable provisions of title I.

However, the department noted that if a tax-exempt organization maintains an unfunded plan primarily for the purpose of providing deferred compensation for a "select group of management or highly compensated employees" within the contemplation of sections 201(2), 301(a)(3) and 401(a)(1) of ERISA, the plan may be exempt from certain of ERISA's provisions relating to participation and vesting, funding and fiduciary responsibility.

IRELL & MANELLA
A LAW PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I have reviewed the Technical Corrections Act of 1987 ("TCA 1987") and I have the following criticisms regarding Section 114 entitled "Amendments Related to Title XIV of the Reform Act":

1. Treatment of Distribution from Trust for Children of a Predeceased Child

Section 2612(c)(2) of the Internal Revenue Code of 1986 ("IRC") creates the so-called "predeceased child exception." Under this section, if property passes to the children of a deceased child, those grandchildren of the transferor (who are normally considered skip persons) move up one generation and are considered non-skip persons for purposes of determining whether a direct skip has occurred. If a trust is created for such grandchildren (with the intervening child predeceasing the transferor) no direct skip occurs upon the trust's creation because such a trust is not a skip person under the rule of section 2612(c)(2).

However, this special rule of section 2612(c)(2) applies only "For purposes of determining whether any transfer is a direct skip." Thus, distributions from the trust to the grandchildren are taxable distributions because the special rule of section 2612(c)(2) does not apply to taxable distributions (which are not direct skips) and the generation assignments of the trust and beneficiaries are not changed pursuant to section 2612(c).

As a solution, I recommend including in the TCA 1987 the following new paragraph (3) as an addition to section 2612(c) of the Internal Revenue Code of 1986:

> "(3) In the case of any transfer which would be a generation-skipping transfer but for paragraph (2), section 2653(a) shall apply as if such transfer were a generation-skipping transfer."

This new paragraph (3) would have the effect of lowering the generation level of the trust to that of the deceased child's generation; thereafter, distributions to the grandchildren would not be generation skipping transfers, but distributions to great-grandchildren would be. I believe this achieves the proper result. I have modeled this paragraph after subparagraph (C) of section 1433(b)(3) which has been proposed in the TCA 1987 as an amendment to section 1433(b)(3) of the Tax Reform Act of 1986 ("TRA 1986"). I believe that making this change would further the congressional intent that no generation-skipping transfer tax be generated where distributions are made to the children of a deceased child of a transferor.

Section 114(g) of the TCA 1987 clarifies the treatment of a $2 million gift (made before January 1, 1990) made for the benefit of a grandchild in trust (which under section 1433(b)(3) of the TRA 1986 is not a direct skip). The TCA 1987 replaces section 1433(b)(3) enacted as part of the TRA 1986 with an expanded set of rules. Subparagraph (C) of these expanded rules provides that even though no generation-skipping transfer has occurred, section 2653(a) of the Internal Revenue Code of 1986 shall be applied as if the transfer had been a generation-skipping transfer for the purposes of determining the generation assignment of the trust. The section 2612(c) situation is analogous to this situation since in both situations property is in trust for the benefit of only grandchildren and no generation skipping transfer has occurred. Therefore, I believe that the modification of section 1433(b)(3) of the TRA 1986 made in the TCA 1987 supports the analagous modification to section 2612(c) that I have recommended above.

2. Repeal of the Charitable Deduction as an Offset Against the Generation-Skipping Transfer Tax on Charitable Lead Trusts

I am strongly opposed to the changes made in Section 114(f)(4)(C) & (D) of the TCA 1987. The repeal of the charitable deduction in calculating the applicable fraction under IRC section 2642 is unsound for several reasons. First, the charitable lead trust is an accepted and widely used dispositive device; the charitable lead trust should not be singled out for harsher treatment than other dispositive devices because the bill drafters personally disfavor the use of such a device. Second, if valuation principles are to be uniform and the valuation tables are to be applied consistently, those principles and tables should be used in all situations where interests are valued. It makes no sense to value property passing to a charitable lead trust for purposes of calculating the applicable fraction of that trust in one manner and to value the property for estate or gift tax purposes in another manner. Carving out an exception seriously undermines any attempt by Congress to implement a uniform system of property valuation for estate, gift and generation skipping transfer tax purposes. Third, this change appears to be a substantive change to the IRC and I do not believe that the TCA 1987 is the proper forum to be making such changes.

Sincerely,

John R. Cohan

John R. Cohan

INSTITUTE OF FOREIGN BANKERS, INC.
200 PARK AVENUE, NEW YORK, NEW YORK 10166
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COMMENTS ON CERTAIN TREATY OVERRIDE PROVISIONS
OF THE TECHNICAL CORRECTIONS ACT OF 1987

The proposed Technical Corrections Act of 1987 (the "TCA"), as introduced in the House and Senate on June 10, 1987, provides that with certain limited exceptions the amendments made by the Tax Reform Act of 1986 will apply notwithstanding any contrary U.S. treaty obligation.1/ For the reasons set forth below, the Institute of Foreign Bankers2/ urges that this broad override of U.S. treaty obligations be deleted. At a minimum, the provision should be amended so it is clear existing U.S. treaties will be available to protect treaty residents against the new branch level taxes, including specifically the branch level tax on "excess interest." In addition, the committee and conference reports accompanying the TCA should clearly express Congress' intent to that effect.

I. Background

The Tax Reform Act of 1986 made numerous changes to the rules governing the federal income tax treatment of foreign taxpayers. In particular, the Reform Act imposed two new branch level taxes on foreign corporations: a branch profits tax and a branch interest tax, which includes a so-called "excess interest" tax. Because banks organized in other countries frequently operate in the United States through branches for regulatory and business reasons, the branch tax primarily affects foreign banks. The excess interest tax is imposed on a foreign bank with a U.S. branch to the extent that interest deducted by the bank for federal income tax purposes under the formula method provided by Treas. Reg. § 1.882-5 exceeds the interest actually paid by its U.S. branch to its depositors or other creditors. Absent a treaty rate reduction or a statutory exemption, the tax is 30 percent of the excess interest amount.

The excess interest tax is imposed on the foreign bank itself, not on any recipient of interest paid by the foreign bank. As a result, foreign banks cannot pass on the cost of the excess interest tax to their creditors. Moreover, there is no such tax imposed on similarly situated U.S. banks or other U.S. corporations. Consequently, in the view of the Institute, the excess interest tax clearly violates the nondiscrimination clauses of most U.S. bilateral tax treaties. It also appears the tax would violate the provisions contained in a number of U.S. tax treaties that prohibit or sharply limit taxation by the United States of interest paid by a foreign corporation. These views of the excess interest tax are shared by many of the foreign treaty partners of the United States.

The staff of the Joint Committee on Taxation have taken the contrary position that the excess interest tax is not discriminatory.3/ This position overlooks the point noted above that the excess interest tax, unlike a withholding tax, is imposed on the payor (*i.e.*, the foreign bank), not the recipient of the interest. In apparent recognition of the questionable validity of this position, the Joint Committee staff go on to state that "if, in any of the cases described above where conflicts are understood not to exist, any treaty is somehow read to bar operation of the Act, the Act is to be effective notwithstanding the treaty." This explicit intent to override treaties is carried out in section 112(y)(2) of the TCA, which provides that with certain narrow exceptions, the amendments made by the Tax Reform Act of 1986 shall apply "notwithstanding any treaty obligation of the United States in effect on the date of the enactment of the Reform Act." Thus, it is clear that if the TCA is enacted in its current form, existing treaty nondiscrimination clauses will not be available to protect foreign banks from the excess interest tax.

II. <u>The Proposed Treaty Override Should Be Deleted</u>

1. <u>The Proposed Rule Is A Major Change In Tax Policy</u>

The treaty override rule proposed in the TCA constitutes a major departure from established U.S. tax policy that would significantly affect U.S. relations with its tax treaty partners. The proposed treaty override would be a unilateral abrogation of bilateral treaty commitments which could not fail to damage the standing of the United States with its trade partners. An action of such sweeping consequence should, at the very least, be considered only after hearings have been held and an effective opportunity for considered comment has been afforded to affected private parties and foreign governments.

2. Overriding Treaties Will Adversely <u>Affect U.S. Corporations Abroad</u>

Congress should be mindful that U.S. tax treaties are mutual compromises designed to benefit U.S. persons and businesses abroad, as well as foreign persons and businesses in the United States. The proposed treaty override would deny foreign persons the benefits negotiated for them by their governments, while retaining the significant benefits the United States has successfully negotiated for U.S. persons doing business overseas. Any action which so drastically undermines the protections negotiated by the treaty partners of the United States will offend these foreign governments and ultimately jeopardize the current favorable tax treatment of U.S. corporations abroad.

Moreover, the proposed treaty override rule comes at a time when the United States is attempting to renegotiate a number of its existing tax treaties. Demonstration by Congress of a willingness to override bilaterally agreed-upon treaty provisions in an unexpected manner will make prospective treaty partners lose confidence in their ability to reach an effective agreement with the United States, and thus severely undercut Treasury's ability to negotiate protection for U.S. individuals and corporations residing or doing business abroad.

In addition, overriding treaty obligations could well trigger other adverse consequences. The intense negative reaction in the Eurobond markets to the recent notice by Treasury of termination of the U.S. treaty with the Netherlands Antilles is a clear indication of the importance foreign investors attach to U.S. treaty commitments.

3. Treaty Overrides Are Not Needed To Combat <u>Abuse Or To Further Other Tax Policy Objectives</u>

Treaty overrides are conceivably defensible on tax policy grounds only in situations where there has been proven and sustained abuse of a treaty by foreign taxpayers with U.S. operations or investments, or where it is clear that failure to enact a treaty override will invite such abuse. For example, a recent treaty override provision contained in the Foreign Investors in Real Property Tax Act of 1980 ("FIRPTA") was reluctantly enacted by Congress primarily to prevent wholesale avoidance of the new tax through treaty abuse. At that time, a number of U.S. treaties would have prevented the tax, but no adequate protection existed in U.S. tax law or in the treaties themselves against treaty-shopping. In order to prevent foreign investors from simply routing their U.S. real estate investments through a country with a favorable treaty, Congress provided that the new tax enacted by FIRPTA would override any contrary treaty provision beginning five years after the enactment of FIRPTA.

In contrast, no treaty abuse or risk of treaty abuse exists in the present context. First, foreign banks, the foreign corporations most widely affected by the branch level tax, are not among the categories of foreign investors that have historically abused income tax treaties. The overwhelming majority of foreign banks with U.S. operations are large publicly-traded institutions in their home countries. These banks have not made improper use of other countries' treaties and the Institute is not aware of any contrary allegation. Second, the Tax Reform Act of 1986 largely eliminated the opportunities for treaty-shopping by foreign taxpayers, primarily through the enactment of "qualified resident" limitations on treaty benefits. These rules are more than adequate to protect against any treaty abuse.4/

4. The Proposed Treaty Override Will Not Produce Significant Revenue

Finally, it must be emphasized that permitting the excess interest tax to override U.S. treaty obligations would not result in a significant revenue gain for the Treasury. Rather, the excess interest tax would be so burdensome that foreign banks simply could not pay the tax and maintain a competitive position as compared with U.S. banks and other foreign banks not subject to the tax.

Foreign banks in the United States already pay a "foreign premium" for their domestic funds depending in large part on the domestic perception of the quality of the bank. Accordingly, the excess interest tax will force foreign banks either to cease or sharply curtail U.S. operations in branch form or, as explained below, to restructure the funding of their U.S. branches in an artificial manner solely to avoid risking imposition of the tax.

5. The Proposed Treaty Override Will Place Foreign Banks At A Competitive Disadvantage

Foreign banks may be forced ~~to seek~~ to reduce or eliminate their exposure to the excess interest tax by funding U.S. branches to the extent possible through increased borrowings in the U.S. financial markets. However, for the reasons noted below, this course of action will serve only (i) to disrupt the normal financing practices of many foreign banks in their home country markets; (ii) to reduce the level of head office funds allocated to U.S. offices and thus to reduce the quasi-capital funds available on the books of those U.S. offices and (iii) to place these foreign banks at an increased competitive disadvantage with regard to the funding of their U.S. operations.

In general, banks have greatest access to the deposit markets in their home countries, and thus can achieve, on average, the lowest cost of funds by borrowing there. For example, U.S. banks typically obtain most of their low-cost funding in the United States because of their large retail deposit base in this country. The same is true for most foreign banks in their respective home countries.5/ However, the excess interest tax will deny foreign banks the use of such low-cost funds for their U.S. branches because the transfer of any such funds to the U.S. branch by the home office would create potential exposure to the excess interest tax. Thus, foreign banks potentially subject to the excess interest tax will be forced to place greater reliance on higher-cost funds in the United States than their domestic competitors and their foreign competitors not subject to the tax.

III. Conclusion

The Institute can see no sound rationale for a tax proposal that will (i) unilaterally abrogate existing U.S. treaty obligations when there has been no demonstrated or asserted treaty abuse; (ii) create a significant risk of adverse reaction by U.S. treaty partners with regard to U.S. corporations operating abroad; (iii) raise no significant amount of new revenue; (iv) disrupt the normal funding operations of many foreign banks; and (v) put foreign banks at an increased competitive disadvantage with regard to their funding operations in the United States.

The principal effects of section 112(y)(2) will be reduced competition in the U.S. banking markets, which can only work to the disadvantage of U.S. corporate borrowers and their shareholders, and reduced foreign investment in the United States with no significant increase in tax revenue. Consequently, the Institute urges that section 112(y)(2) of the TCA be deleted or, at a minimum, amended in the manner noted above.

1/ H.R. 2636, S. 1350, 100th Cong., 1st Sess. § 112(y)(2) (1987).

2/ The Institute of Foreign Bankers is a trade association representing over 230 foreign banks from more than 50 countries with operations in the United States.

3/ Staff of Jt. Comm. on Taxation, 100th Cong., 1st Sess., Description of the Technical Corrections Act of 1987 (Jt. Comm. Print June 15, 1987) at 235.

4/ Importantly, these rules have been criticized by several European treaty partners of the United States. We understand that six European nations have submitted or will submit to Treasury a demarche setting forth their position on this issue. This concerted action by the European governments is further evidence of the sensitivity of foreign governments to unilateral U.S. legislative overrides of treaties.

5/ To the extent these lower-cost funds are currently used by the U.S. office of a foreign bank, the lower cost of such funds is reflected in the foreign bank's calculation of its interest expense deduction under Treas. Reg. § 1.882-5. Thus, foreign banks gain no tax advantage by using such low-cost funds in their U.S. operations.

COVINGTON & BURLING

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Ms. Mary McAuliffe
Minority Chief of Staff
Committee on Finance
Room SD-G08
United States Senate
Washington, D.C. 20510

Re: Technical Corrections Bill (H.R. 2636)
Section 112(a)(1)(A) (Foreign Tax Credit)

Dear Ms. Wilcox and Ms. McAuliffe:

On behalf of International Business Machines Corporation ("IBM"), I am writing to urge the Committee to adopt a technical correction clarifying the application of the separate foreign tax credit limitations for financial services and passive income to income earned by foreign subsidiaries that lease a local affiliate's manufactured product.

In some cases, to comply with foreign regulatory restrictions, a foreign operating affiliate of a U.S. company must set up a local leasing subsidiary to lease the operating affiliate's products to local customers. Absent clarifying legislation, income earned by the leasing subsidiary inappropriately could be thought to fall within the purview of "financial services" or "passive" income, with the result that the credit for foreign taxes paid on that income would be subject to a separate limitation under Section 904(d).

The leasing income would not be subject to a separate foreign tax credit limitation if the operating affiliate had engaged in the leasing activities directly. Because the operating company would not be "predominantly engaged" in financial services activities, its income would not be within to the separate financial services basket. Section 904(d)(2)(C) (as amended by the Section 112(a)(1)(A) of the Technical Corrections Bill). Similarly, because the leasing activities would be an adjunct of the operating affiliate's manufacturing or marketing efforts, the income would be "active rental" income, and hence would be excluded from the definition of passive income. Section 904(d)(2)(A)(i), referencing Section 954(c)(2)(A).

This result should obtain similarly where the foreign operating company is required by local law to place its leasing operations in a local subsidiary. In the domestic context, the Conference Report recognizes that it may be appropriate to apply the "active rental income" rules on a consolidated group basis. Conf. Rep. 99-841, 99th Cong., 2nd Sess. II-566 (1986). The Technical Corrections Bill should contain a similar clarification that this rule (as well as the "predominantly engaged" rule) may be applied on a group basis in the case of a foreign affiliate and its local leasing subsidiary. Proposed bill language to this effect is attached.

Thank you for your attention to this matter.

Sincerely,

Andrew H. Friedman

Andrew H. Friedman

PROPOSED TECHNICAL CORRECTION

Section 904(d)(2) of the Internal Revenue Code of 1986 is amended by adding at the end thereof the following new subparagraph:

> "(J) LEASING ACTIVITIES. -- Whether income received by a corporation that engages primarily in leasing activities is passive income or financial services income shall be determined as if the recipient and its affiliated corporations (within the meaning of Section 1504(a) without reference to the limitation of Section 1504(b)(3)) that are organized under the laws of the same country as the recipient were a single taxpayer."

July 23, 1987

INTERNATIONAL BUSINESS MACHINES CORPORATION

PROPOSED TECHNICAL CORRECTION TO THE SUPERFUND REVENUE ACT OF 1986

Submitted for the Hearings of the Senate Finance Subcommittee on Taxation and Debt Management Technical Corrections Act of 1987

International Business Machines Corporation ("IBM") urges the adoption of a technical correction to the Superfund Revenue Act of 1986 that would cure a manifest error in the computation of the Superfund tax, affecting the competitive position of United States corporations operating abroad through branches and subsidiaries. The technical error is the inclusion of foreign taxes (or the Section 78 "gross-up" for foreign taxes deemed paid by a foreign subsidiary) in the base upon which the Superfund tax is imposed where the taxpayer has claimed the foreign tax credit for income tax purposes.

The Superfund Revenue Act imposes a new environmental tax based generally on corporate alternative minimum taxable income ("AMTI"). The environmental tax is imposed even if the corporation is not otherwise subject to the alternative minimum tax. No credits are allowable for purposes of the environmental tax.

For regular and alternative tax purposes, a taxpayer that claims the foreign tax credit is not entitled to deduct from taxable income the foreign taxes paid by a branch operating abroad. To allow a deduction in conjunction with the credit would provide the taxpayer with a double benefit, and also would produce an inaccurate comparison between the U.S. and foreign tax rates for purposes of the foreign tax credit limitation. For these same reasons, a corporation claiming a credit for foreign taxes deemed paid by a foreign subsidiary must increase its taxable income by the amount of those taxes pursuant to Section 78 of the Code. However, the inclusion of foreign taxes in a corporation's taxable income never increases U.S. income tax by more than the credit allowed. A deduction for foreign taxes paid by a branch is allowed, and no Section 78 "gross-up" is required, in circumstances where the taxpayer does not claim the foreign tax credit. It is therefore well established that the inclusion of foreign taxes in the income of a corporation is appropriate only when an offsetting foreign tax credit is available.

The alternative minimum tax allows a foreign tax credit, albeit limited to 90 percent of the alternative tax. As a result, for taxpayers choosing the benefits of the credit, foreign taxes and the Section 78 gross-up amount appropriately should be included in AMTI for alternative minimum tax purposes. The Superfund tax on the same base, however, allows no foreign tax credit. Consequently, the Superfund provisions tax phantom income never received in this country, a result that cannot be rationally defended.

The practical effect of including foreign taxes and the Section 78 gross-up in the base upon which the Superfund tax is imposed is to subject U.S. companies with foreign source income to a two-fold competitive disadvantage. First, the provision discriminates unfairly against U.S. companies with multinational operations versus U.S. corporations with only domestic operations. Secondly, a U.S. company operating abroad would be disadvantaged over its foreign competitors operating in the foreign marketplace. These consequences clearly are not desirable from a policy perspective, especially given the lack of technical justification for the erroneous inclusion of foreign taxes in the Superfund tax base.

Proposed Technical Correction

IBM proposes the following as a technical correction to the computation of the Superfund tax base:

Section 59A(b) of the Internal Revenue Code of 1986 is amended by replacing the period at the end thereof with a semicolon, and adding the following language:

> "and, if the taxpayer chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for the taxable year, reduced by
>
> > (3) the amounts provided in the applicable paragraph of section 901(b), plus
> >
> > (4) the taxes deemed to have been paid under sections 902 and 960."

STATEMENT OF

THE INTERNATIONAL COUNCIL OF
SHOPPING CENTERS

ON THE

TECHNICAL CORRECTIONS ACT OF 1987
(S. 1350)

INTRODUCTION

My name is Wallace R. Woodbury. I am Chairman of the Board of Woodbury Corporation, Salt Lake City, Utah, a long-established real estate development, brokerage, management and consulting firm. I am also chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and a member of the Board of Trustees. I submit this testimony on the proposed Technical Corrections Act of 1987 (S. 1350) on behalf of the members of ICSC.

ICSC is the trade association of the shopping center industry with over 21,000 members. Membership includes developers, owners, retailers, lenders, and others having a professional interest in the shopping center industry. ICSC members represent most of the 28,500 shopping centers in the United States. In 1986, these centers generated $554 billion in retail sales, representing 54% of total retail sales (exclusive of automotive sales). These centers generated $20.3 billion in sales tax revenues and employed 6.9 million people.

STATEMENT

(1) Material Participants in the Real Estate Business

Although the Tax Reform Act of 1986 contained many provisions increasing the taxes paid by the real estate industry, there is one provision which is so discriminatory, so unfair and so central to our business that we must call it to your attention and request that it be corrected at the earliest opportunity. We refer specifically to those parts of the passive loss rules which define all rental income as passive, regardless of the material participation of the taxpayer in producing that income. Shopping center developers are not passive investors looking for tax deductions. They are full-time businessmen and women who, if they were in any other industry, would be allowed to offset losses from one part of their business against all other income. However, material participants in the real estate business cannot offset losses from rental properties against other kinds of income, or even against such real estate related income as management and development fees and commissions. This is a grossly unfair discrimination against one industry -- real estate.

When the tax reform process started, its stated objective was to eliminate distortions in business planning caused by taxes. It is most strange that a discriminatory provision, which singles out recipients of rental income for special onerous treatment, emerged from a reform process dedicated to producing a "level playing field" among taxpayers. The passive loss provisions will have the clear effect of penalizing and discouraging development of and investment in real estate -- a distinct tilt to the playing field.

This special rule for material participants in the real estate business works in a particularly harsh manner against the new developer trying to enter the business and will work to reduce competition with all the attendant unwholesome effects of such a result. The rule means that a new entrant must finance his new projects, which typically have losses in the early years, with after-tax dollars, while entrepreneurs in all other fields can use pre-tax dollars.

For example, assume a taxpayer owns and manages a clothing store and a restaurant. Both produce active income or loss, and a loss from one of these stores can offset income from the other. If both stores show a net loss, he can offset this loss against portfolio or other income.

Compare this with a taxpayer in the real estate business. He has losses from rental properties and management fees from other properties, a not uncommon situation. Even though this is all part of his real estate business, the 1986 tax act does not permit the losses from rents (passive losses) to offset the income from the management fees (active income). This is true even if the rental losses are real, out-of-pocket losses, i.e., the loss is greater than the depreciation deductions.

The passive loss rules were intended to restrict truly passive investors from offsetting rental losses against salary and professional income. We are not objecting to that result. Although we do not think it was necessary to go as far as the Tax Reform Act of 1986 did to achieve this result, we consider the elimination of the tax-abusive real estate transactions to be salutary. However, we object to the classification of the real estate related income of full-time, active real estate developers as "passive," particularly when material participants in all other businesses are allowed to offset all their income and losses.

When Congress voted on the 1986 tax act, it did not have the opportunity to vote on particular provisions separately. We believe that many Members of the House and Senate were disturbed by the unfairness of this provision. Accordingly, the passive loss rules should be amended to provide for a material participant exception for real estate at the earliest opportunity.

(2) Installment Sales

ICSC supports the provisions of the proposed Act in section 108(f) of S.1350 which clarify the application of the new rules to pre-1987 installment sales transactions. The bill would clarify that payments received after January 1, 1987 would be categorized as active or passive as required by the new law. This provides a desirable consistency in treatment of such payments.

However, ICSC believes an even better solution to the installment sales issue is that contained in S. 719 which restores the pre-1987 installment sales rules for non-dealers. The Tax Reform Act of 1986 limits the use of the installment sales method by treating as a payment in the year of the sale an imputed amount equal to the face amount of the installment obligation multiplied by the ratio of the taxpayer's total debts (broadly defined) to his total assets (the adjusted basis of his assets plus the amount of all installment obligations).

This calculation requires data on both debts and asset values that is not required for any other tax or business purpose. Therefore, this information is not readily available in taxpayers' records for either the taxpayer's determination of the tax or a revenue agent's review on audit, thus creating difficult compliance and enforcement problems.

The present "proportional disallowance" rule law is unfair and not supported by sound tax policy grounds. It makes the unwarranted assumption that there is some nexus between all of the taxpayer's debt and his installment obligations. In the case of real estate investments, each project is financed to stand alone. It is improper for the tax code to consider totally extraneous investments in order to impute, as cash received, an artificial amount equal to the ratio of total debt, including unrelated debt, to book value of total assets, including unrelated assets. This is not a situation where the purchase money note or the underlying property is used as security for a separate loan.

The practical effect of the installment sales provision is to discourage its use in the real estate business. This constitutes an unnecessary restriction on business financing and is unnecessary to correct any perceived abuse in the tax law. This is especially true in view of the fact that the use of the installment method provides only a deferral of tax, not an escape from tax, for the period when there is insufficient cash to pay the tax. The tax policy consideration that a tax should be assessed only when cash is available from a transaction to pay the tax is sound and should be reinstated. It is additionally justified in the case of the installment method because the seller may never receive the payments provided by the obligation. For example, payments under an installment sales agreement may never be made if the buyer becomes insolvent, although the seller has paid taxes based on the "proportional disallowance" rule.

We appreciate the opportunity for submitting these comments and hope they are of use to you.

INTERNATIONAL PAPER COMPANY
TWO MANHATTANVILLE ROAD, PURCHASE, NEW YORK 10577

Senator Lloyd Bentsen,
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Senator Bentsen:

Pursuant to your release of June 30, 1987, we respectfully submit this letter of comment for inclusion in the record of the hearings to be held on July 22, 1987, regarding S.1350, the Technical Corrections Act of 1987 (the "Act"). This comment is limited to Section 107(c)(4) of the Act.

The above referenced provision amends Section 57(a)(3) of the Code by striking out "section 422A" and inserting in lieu thereof "section 422A whether or not the holding period requirements of section 422A are met." This provision would make a material and substantive change in the tax consequences of incentive stock options (ISO's) by subjecting individual taxpayers to the alternative minimum tax, notwithstanding that the taxpayer has made a disqualifying disposition of the ISO shares.

The treatment of an item as ordinary income and as a tax preference for alternative minimum tax purposes runs contrary to the purpose or underlying tax theory of the alternative minimum tax. The alternative minimum tax is designed for the purpose of requiring taxpayers who benefit from special treatment or deductions under the law to pay at least a minimum amount of tax. See IRS Publication 909. Pursuant to Sections 422A(a)(1) and 421(a) of the Code, no income is realized upon the grant or exercise of a qualified ISO if no disposition of such shares is made by the employee within two (2) years from the date of granting of the option, nor within one (1) year after the transfer of such shares to the employee. However if the above holding period requirements are not met, the employee is treated as having received income in the year of disposition in an amount equal to the difference between the exercise price and fair market value of the stock on the date of exercise (Section 421(b); Prop. Reg. Section 1.422A-1(b)). Therefore, in a disqualifying disposition, there is no special tax treatment from which the taxpayer is benefiting which should trigger application of the alternative minimum tax. Application of the alternative minimum tax in this situation is therefore contrary to the purpose of the alternative minimum tax.

There is no basis in legislative history for this proposed change in tax treatment of ISO's. In fact, when Congress amended Code Section 57 to include the ISO spread as a tax preference, this issue was addressed. The Conference agreement to the Tax Equity and Fiscal Responsibility Act of

1982 provides: "It is intended that the incentive stock option preference not apply where there is an early disposition of the stock acquired through the exercise of the option." See H.R. Rep. No. 97-760 (Conf. Rep.), 97th Cong. 2d Sess. 475 (1982), 1982-2 C.B. 600, 603. The IRS appears to have a similar view as seen in a recent letter ruling. In PLR 8713054, the IRS ruled that Section 57 (a)(10) of the Code (the ISO preference) would not apply in the situation where by June 16, 1987, there was a proposed disposition of ISO stock acquired on June 16, 1986.

The Tax Reform Act of 1986 (TRA) did not alter the treatment of the ISO spread as an item of tax preference. The only substantive change made by the TRA with respect to this item of preference was the addition of Code Section 57(a)(3)(B) which provides a basis adjustment rule for minimum tax purposes when determining the amount of gain or loss on a subsequent disposition of ISO shares. In light of the above, it is apparent that the Act's provision is much more than a technical correction, but is a significant material amendment without support in legislative history or intent.

Another apparent problem with this provision of the Act is its retroactive effective date. Taxpayers justifiably have relied upon legislative intent and more recently the above referenced IRS ruling in concluding that the minimum tax would not apply when there is a disqualifying disposition of ISO stock. The effective date of this provision of the Act is apparently governed by Section 119 of the Act which causes it to be treated as if included in the provision of the Tax Reform Act to which such amendment relates. This would indicate an effective date for tax years beginning after December 31, 1986. Certainly fairness to taxpayers who have relied on prior law in making their decisions dictates that the change, if made, be made on a prospective basis only.

One of the purposes of your request for comments was to receive recommendations for additional items to be included in the Act. There is a need for clarification in the area of elimination of the ISO tax preferences by an early or disqualifying disposition of the stock. Section 57(a)(3) defines the ISO preference in terms of an ISO as defined in Section 422A. Therefore, if an early or disqualifying disposition occurs in the same tax year, the option would not meet the requirements of 422A and thus there would be no ISO preference. However, there is no guidance as to what occurs when the disqualifying disposition occurs in a subsequent tax year. This issue merits attention and clarification, particularly in light of PLR 8713054.

The TRA made a significant reduction in the benefits of ISO's by virtue of the elimination of the capital gains deduction. If this provision of the Act is passed, it will raise the question as to whether there are any real benefits left in the use of incentive stock option plans to attract and retain personnel.

In conclusion, the proposed change to Section 57(a)(3) is a material substantive change to the Code which is void of basis in legislative intent or sound tax theory.

Very Truly Yours,

John T. Leyden

JOHN T. LEYDEN

Sept. 10, 1987

The Honorable Lloyd Bentsen
703 SHOB
Washington, D.C. 20510-4301

Dear Senator,

The Tax Reform Act of 1986 was clearly formulated by legislators who have no knowledge whatever about the creative process of writing: deductions for expenses on unsold material are no longer permitted, all expenses must be allocated to specific projects, and (this one defies logic) the writer must be able to estimate the earning power of what he has sold in order to spread the deductions out over the earning life of the work for which he has incurred expenses. Under the new law, only the financially secure author can continue to work.

I repectfully request that you use your influence to demand a clarification of the Technical Corrections Bill S1350, stating that free-lance authors' expenses in researching and writing a book not be subject to capitalization rules. Perhaps, with your help, common sense will prevail and this threat to American literature will be removed.

Sincerely

Teresa W. Irvin

Teresa W. Irvin
P.O. Box 13328
El Paso, TX 79913

WRITTEN STATEMENT SUBMITTED BY CATHERINE L. HERON
FOR INCLUSION IN THE PRINTED RECORD

The accompanying statement is submitted to the Subcommittee on Taxation and Debt Management of the Committee on Finance of the United States Senate by Catherine L. Heron, Deputy General Counsel of the Investment Company Institute, 1600 M St., N.W., Washington, D.C. 20036 (telephone 293-7700). The statement sets forth the Institute's concerns regarding certain provisions of S.1350, the Technical Corrections Act of 1987, that relate to the tax treatment of regulated investment companies and their shareholders. The statement addresses the following issues.

I. Proposed Amendment to I.R.C. Section 851(b)(3) to Include Foreign Currency Gains

II. Mergers of RICs with Other Investment Companies

III. The Institute's Proposed Technical Corrections to Section 4982

   A. Computation of Required Distribution

   B. Preservation of Earnings and Profits to Support Dividends Paid Deduction

IV. Partnership and Trust Income Under Section 851(b)(2)

V. Exemption From Section 851(b)(3) For RICs in Liquidation

STATEMENT OF IU INTERNATIONAL CORPORATION

This statement is submitted by IU International Corporation, 919 North Market Street, Wilmington, Delaware, with executive offices at 1500 Walnut Str3et, Philadelphia, Pennsylvania. IU International Corporation (IU) is a diversified services company with operations in food and inventory distribution, environmental services and trucking services. IU has operations concerning one or more of these services in Pennsylvania, Illinois, Texas, Florida, Kansas, Tennessee, Ohio, Colorado, West Virginia, Delaware, Alabama, Arkansas, Georgia, Indiana, Michigan, Minnesota, Missouri, New Jersey, New York, Oklahoma, California, Maine, New Hampshire, Oregon, Washington, Wisconsin, Massachusetts, Connecticut, Montana, South Dakota, Rhode Island, Nebraska and North Dakota, as well as several other states. This statement relates to a proposed technical amendment to the Tax Reform Act of 1986, specifically to section 633(f) of that legislation.

On October 2, 1973, IU owned approximately 86 percent of Canadian Utilities Limited (CUL), an Alberta-based, regulated Canadian natural gas and electric utility company. Pursuant to direct and indirect pressure by the Canadian Government to increase Canadian ownership of Canadian based companies, particularly in the energy business, IU had sought to increase Canadian ownership in CUL and reduce the IU interests in CUL. By November 1979, IU's ownership in CUL had dropped to approximately 58 percent. This pressure continued, however, and became particularly acute by 1980. In fact, as far as could be determined, no other Canadian gas or electric utility had the level of non-Canadian ownership and control IU had in CUL. In addition, IU was under statutory/regulatory requirements in the United States to limit the percentage of IU stock owned by non-United States' citizens.

Consequently, in 1980, IU entered into a transaction which would both reduce the non-Canadian ownership of CUL and reduce the Canadian/foreign ownership of IU. Or stated differently, the transaction would increase Canadian ownership of CUL and increase United States ownership of IU. In essence, an unrelated Canadian company made a tender offer to buy IU shares. After purchasing those IU shares, this Canadian company exchanged the IU shares with IU for IU's CUL shares. Based on a reading of the then current law I.R.C. §311(d)(2)(B), two law firms gave opinions to IU that the exchange was non-taxable. Indeed, the transactions met the literal statutory requirements, and were within the intent of the statute. Subsequent to the IU transaction, two other publicly-held companies, Esmark and Brunswick, undertook substantially identical §311(d)(2)(B) transactions.

In 1982, Congress repealed §311(d)(2)(B) so that these exchanges would be taxable in the future. Nevertheless, the Internal Revenue Service alleged retroactively that all three of the transactions (IU, Brunswick and Esmark) would be taxable. In September 1986 (the date of Conference action on the Tax Reform Act), all three companies were in some stage of audit procedures with the IRS.

Section 633(f) of the 1986 legislation effectively rejects the Service's position but only with respect to one (Brunswick) of the three affected companies. Section 633(f) does not technically apply to the Esmark and IU transactions even though they are essentially identical and, in fact, preceded and served as the pattern for the Brunswick transaction. Simple fairness requires that the existing provision should not be confined to a single company but should be expanded to cover the other two companies in identical situations.

S. 1350 should remove this perhaps unintended unfairness and give equal relief to all three companies.

INTERNATIONAL PAPER COMPANY
TWO MANHATTANVILLE ROAD, PURCHASE, NEW YORK 10577

Senator Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Senator Bentsen:

Pursuant to your release of June 30, 1987, we respectfully submit this letter of comment for inclusion in the record of the hearings to be held on July 22, 1987, regarding S.1350, the Technical Corrections Act of 1987 (the "Act"). This comment is limited to Section 107(c)(4) of the Act.

The above referenced provision amends Section 57(a)(3) of the Code by striking out "section 422A" and inserting in lieu thereof "section 422A whether or not the holding period requirements of section 422A are met." This provision would make a material and substantive change in the tax consequences of incentive stock options (ISO's) by subjecting individual taxpayers to the alternative minimum tax, notwithstanding that the taxpayer has made a disqualifying disposition of the ISO shares.

The treatment of an item as ordinary income and as a tax preference for alternative minimum tax purposes runs contrary to the purpose or underlying tax theory of the alternative minimum tax. The alternative minimum tax is designed for the purpose of requiring taxpayers who benefit from special treatment or deductions under the law to pay at least a minimum amount of tax. See IRS Publication 909. Pursuant to Sections 422A(a)(1) and 421(a) of the Code, no income is realized upon the grant or exercise of a qualified ISO if no disposition of such shares is made by the employee within two (2) years from the date of granting of the option, nor within one (1) year after the transfer of such shares to the employee. However if the above holding period requirements are not met, the employee is treated as having received income in the year of disposition in an amount equal to the difference between the exercise price and fair market value of the stock on the date of exercise (Section 421(b); Prop. Reg. Section 1.422A-1(b)). Therefore, in a disqualifying disposition, there is no special tax treatment from which the taxpayer is benefiting which should trigger application of the alternative minimum tax. Application of the alternative minimum tax in this situation is therefore contrary to the purpose of the alternative minimum tax.

There is no basis in legislative history for this proposed change in tax treatment of ISO's. In fact, when Congress amended Code Section 57 to include the ISO spread as a tax preference, this issue was addressed. The Conference agreement to the Tax Equity and Fiscal Responsibility Act of 1982 provides: "It is intended that the incentive stock option preference not apply where there is an early disposition of the stock acquired through the exercise of the option." See H.R. Rep. No. 97-760 (Conf. Rep.), 97th Cong. 2d Sess. 475 (1982), 1982-2 C.B. 600, 603. The IRS appears to have a similar view as seen in a recent letter ruling. In PLR 8713054, the IRS ruled that Section 57 (a)(10) of the Code (the ISO preference) would not apply in the situation where by June 16, 1987, there was a proposed disposition of ISO stock acquired on June 16, 1986.

The Tax Reform Act of 1986 (TRA) did not alter the treatment of the ISO spread as an item of tax preference. The only substantive change made by the TRA with respect to this item of preference was the addition of Code Section 57(a)(3)(B) which provides a basis adjustment rule for minimum tax purposes when determining the amount of gain or loss on a subsequent disposition of ISO shares. In light of the above, it is apparent that the Act's provision is much more than a technical correction, but is a significant material amendment without support in legislative history or intent.

Another apparent problem with this provision of the Act is its retroactive effective date. Taxpayers justifiably have relied upon legislative intent and more recently the above referenced IRS ruling in concluding that the minimum tax would not apply when there is a disqualifying disposition of ISO stock. The effective date of this provision of the Act is apparently governed by Section 119 of the Act which causes it to be treated as if included in the provision of the Tax Reform Act to which such amendment relates. This would indicate an effective date for tax years beginning after December 31, 1986. Certainly fairness to taxpayers who have relied on prior law in making their decisions dictates that the change, if made, be made on a prospective basis only.

One of the purposes of your request for comments was to receive recommendations for additional items to be included in the Act. There is a need for clarification in the area of elimination of the ISO tax preferences by an early or disqualifying disposition of the stock. Section 57(a)(3) defines the ISO preference in terms of an ISO as defined in Section 422A. Therefore, if an early or disqualifying disposition occurs in the same tax year, the option would not meet the requirements of 422A and thus there would be no ISO preference. However, there is no guidance as to what occurs when the disqualifying disposition occurs in a subsequent tax year. This issue merits attention and clarification, particularly in light of PLR 8713054.

The TRA made a significant reduction in the benefits of ISO's by virtue of the elimination of the capital gains deduction. If this provision of the Act is passed, it will raise the question as to whether there are any real benefits left in the use of incentive stock option plans to attract and retain personnel.

In conclusion, the proposed change to Section 57(a)(3) is a material substantive change to the Code which is void of basis in legislative intent or sound tax theory.

Very Truly Yours,

John T. Leyden

JOHN T. LEYDEN

ORAL STATEMENT OF
DAVID SILVER
PRESIDENT
INVESTMENT COMPANY INSTITUTE

Mr. Chairman. My name is David Silver. I am President of the Investment Company Institute, the association which represents America's mutual fund industry. I appreciate the opportunity to testify today.

Mutual funds have become a preferred vehicle for millions of middle income, working Americans trying to accumulate savings and retirement income.

The subject of our comments is Internal Revenue Code Section 67(c): a provision added as a technical amendment in last year's tax reform bill. Unless corrected Section 67(c) will impute phantom or fictional income to nearly 20 million U.S. taxpayers next January.

The section was added in the Senate last year in the last hour of the Senate's consideration of the bill, without hearings or debate, in a package with hundreds of other amendments labelled as technical and represented as having no substantive impact. The infirmities which afflict Section 67(c) flow from its genesis as a technical amendment shielded from the rigors of debate or time for reflection.

First, the section is unfair to twenty million individual taxpayers by saddling them with phantom income. To the average taxpayer phantom income will truly be an amazing concept. The section works like an alchemist's formula transmuting a mutual fund's business expenses into income for the fund's shareholders. As with other attempts to turn lead into gold, this one also fails. For the so-called "income" to be received by these 20 million shareholders cannot be banked, cannot be invested, and cannot be used to buy groceries. The only thing it is good for is to pay taxes on.

Section 67(c) is therefore grotesque as a matter of tax equity.

A second infirmity arises from the fact that these twenty million taxpayers will receive 1099s which show more taxable income than shown on their account statements. Confused and resentful many of these taxpayers will pay their taxes on the dollars they know they received, not on fictional amounts. The result will be administrative chaos as there will be a gigantic mismatch between tax returns and 1099s. IRS will be relegated to trying to collect relatively small amounts from millions of taxpayers.

Section 67(c) is therefore absurd from the viewpoint of administration of the tax laws.

Third, the section is unfair as a competitive matter. As shown in Attachment B to our written statement, no financial product competitive with mutual funds is saddled with phantom income.

Section 67(c) therefore violates another cardinal tenet of tax policy -- that of neutrality.

Thus, Section 67(c) fails every test of tax policy -- from fairness to neutrality and ease of administration.

Behind me are charts illustrating the impact of Section 67(c) on the actual tax liability of a 78 year old retired widow with mutual fund investments which produced $6,898.85 in income in 1986. Because of this provision, her tax bill, assuming the same income, will increase from $495 in 1986 to $511 in 1987. Without phantom income, her 1987 tax bill would be only $393. Section 67(c) has eliminated her entire benefit from the 1986 Tax Reform Act.

Mr. Chairman: the policy considerations I have mentioned this morning, and the bizarre result illustrated on these charts in human terms, is why you, Senator Moynihan and 13 of your Finance Committee colleagues have joined together to introduce S. 1489 to correct Section 67(c).

I would be happy to answer any questions.

TESTIMONY OF
DAVID SILVER, PRESIDENT
INVESTMENT COMPANY INSTITUTE
BEFORE THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
ON TECHNICAL CORRECTIONS TO THE
TAX REFORM ACT OF 1986
JULY 22, 1987

- Section 67(c) was added as a technical amendment to the Tax Reform Act of 1986 as an anti-evasion provision.

- Instead, the effect of the Section will be to impute "phantom income" -- income never received -- to 20 million mutual fund shareholders.

- Most mutual fund shareholders are working Americans saving for retirement or retirees relying heavily on their investments for income. They will be astonished to find additional taxable income imputed to them on these savings.

- Furthermore, the section places mutual funds at an unfair competitive disadvantage. Virtually every other investment product, which competes with mutual funds, is not subject to this provision.

- Fifteen members of the Finance Committee have cosponsored legislation, S. 1489, to alleviate the discriminatory impact of Section 67(c) upon mutual fund shareholders and mutual funds.

- S. 1489 is a necessary technical change and should be enacted in the earliest available legislative "vehicle." Absent timely congressional action, relief for taxpayers for 1987 may not be possible.

- I.R.C. Section 67(c), added as a technical amendment last year, imposed an unfair and discriminatory tax on 20 million mutual fund shareholders. This was simply improper and, we believe, unintended. S. 1489, endorsed by three-fourths of the Finance Committee, provides the proper remedy. It should be passed at the earliest available opportunity.

TESTIMONY OF
DAVID SILVER, PRESIDENT
INVESTMENT COMPANY INSTITUTE

I. INTRODUCTION

Mr. Chairman. I appreciate the opportunity to testify today. My name is David Silver. I am president of the Investment Company Institute, the association which represents America's mutual fund industry. The Institute's membership includes 2,086 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members hold assets accounting for approximately 90% of total industry assets and have over 29 million shareholders.

Mutual funds clearly have become a highly preferred investment vehicle for millions of middle income investors and working Americans trying to accumulate savings and retirement income. They provide investors of moderate means the opportunity to obtain professional investment management and diversification of their investments. Over half of all mutual fund shareholders (excluding those in tax-exempt funds*) have household incomes of less than $50,000; forty percent have adjusted gross income under $40,000. Excluding money market mutual funds, thirty-eight percent of all fund shareholders are retired. Many of these retirees depend heavily on their mutual fund investments for day-to-day living expenses.

The subject of our comments today is Internal Revenue Code Section 67(c): a provision added to the tax code in last year's tax reform measure. Absent timely congressional action, Section 67(c) could adversely affect almost every mutual fund and mutual fund shareholder in America. As currently written, Section 67(c) will impute phantom taxable income, i.e., income not received but included in taxable income, to nearly 20 million U.S. taxpayers this year. Mutual fund households will have to pay taxes on $100 -$200 or more of income they never receive.

We are most pleased, Mr. Chairman, that 15 members of the Senate Finance Committee recently joined in introducing S. 1489, a bill authored by Senator Moynihan to remove the discriminatory impact of Section 67(c) upon mutual funds and mutual fund shareholders. We hope that this Committee will agree that S.1489 would be a suitable technical change to last year's tax reform law which ought to be enacted as part of the earliest available legislative "vehicle."

Please consider the following reasons for enacting S.1489 as promptly as possible.

II. SECTION 67(c) VASTLY OVERSHOT THE MARK INTENDED BY CONGRESS LAST YEAR.

A. Section 67(c) Was Intended To Be a Narrow Anti-evasion Provision.

I.R.C. Section 67, added to the Code last year, imposes a two percent floor on certain "miscellaneous itemized deductions," including deductions under Section 212 for expenses incurred in producing investment income. Section 67(c) was added as one of hundreds of technical amendments at literally the last hour of the Senate's consideration of the Tax Reform Act. On its face it appears to be solely an anti-evasion or "loophole closing" provision: to prevent the indirect deduction through "pass-thru entities" of amounts not deductible if incurred by an individual directly.

Theoretically, I suppose, some sort of specialized "mutual fund" might be established by a handful of taxpayers seeking to avoid Section 67's restrictions -- although I believe that hypothetical possibility is farfetched. Were that to occur, the application of Section 67(c)'s "loophole closing" intent would be appropriate.

However, Section 67(c), as written, went far beyond that narrow prophylactic purpose. Regulations may be issued to effectuate Section 67(c) that would impute phantom taxable income to virtually all individual mutual fund shareholders in an amount equal to a portion of the operating expenses of their mutual fund. These operating expenses have, in the past, been recognized by the Internal Revenue Service as ordinary and necessary business expenses. Under the new provision, however, a fund shareholder will be treated as having personally incurred the expenses and (if he or she itemizes) will be permitted to deduct the expenses only if, together with the shareholder's other miscellaneous itemized deductions, the expenses exceed the two percent floor.

B. Section 67(c) Inappropriately Affects 20 Million Shareholders of Publicly Offered Mutual Funds.

It is patently ludicrous that a narrow anti-evasion provision should impute phantom income to 20 million shareholders of publicly-offered mutual funds. The more so when one considers that Section 67(c) will apparently impute income to nonitemizers as well as itemizers and that nonitemizers will in no event be able to deduct these expenses. Of these mutual fund shareholders who do itemize their deductions, only a small percentage will have expenses in excess of the two percent floor. Section 67(c) will thrust a peculiar new tax burden upon 20 million taxpayers which defies reality.

Who are these taxpayers? I can assure the Committee they are not wealthy manipulators of the tax code. Nor are they conversant with such arcane concepts as phantom income. Many shareholders are pensioners or working Americans building their retirement savings. They thought the Congress was reducing their overall tax burden last year via increases in the standard deduction and personal exemption amounts and decreases in the effective tax rates. They will be astonished next January to see on their Forms 1099 that the Congress actually cut those tax benefits by imputing to them significant amounts of phantom income.

C. The Phantom Taxable Income Created by Section 67(c) Unfairly Increases the Tax Burden of Mutual Fund Shareholders.

The impact of Section 67(c) will first be felt by mutual fund shareholders next January. They will receive a Form 1099 which includes in taxable income an amount greater than that which is reflected in their year-end statements of account or their own checkbooks.

The effective rate of tax on all mutual fund dividends will be increased significantly by Section 67(c). In the case of shareholders in equity funds, the effective tax rate on dividends will be increased by 20 percent or more for investors of every income level.

The penalty imposed by Section 67(c) falls even more heavily on older shareholders than it does on younger shareholders. This is because retirees depend heavily on their mutual fund investments for living expenses. In addition, elderly shareholders are less likely to be able to deduct any portion of the imputed income, because they either use the standard deduction or have insufficient miscellaneous deductions to exceed the 2 percent floor. I would draw the Committee's attention to Attachment A which illustrates the impact of Section 67(c) on elderly shareholders.

D. The Enforcement of Section 67(c) Will Be An Administrative Nightmare.

And what will be the impact upon mutual funds and the U.S. government? In a word, chaos! Ease of entry and swift redeemability have been a hallmark of mutual fund investing. Trillions of dollars are invested and withdrawn from mutual funds each year. A severe administrative logjam could develop in identifying millions of individual shareholders and then allocating phantom income to them. It will be a worse problem for the government. The IRS will face an administrative nightmare in trying to collect the tax attributable to Section 67(c). The income reported on Form 1099, which will include Section 67(c) "phantom income", will disagree with shareholders' own records and yearly account statements received from the funds. Millions of shareholders will be confused by this discrepancy and will simply report on their tax returns the income they know they received. The result will be a mismatch between tax returns and 1099s, leaving the IRS in the unenviable position of trying to collect $30, $40 or $100 from millions of citizens who do not believe that they have underpaid their taxes.

E. Section 67(c) Puts Mutual Funds At An Unfair Competitive Disadvantage.

Finally, Section 67(c) might at least have made logical sense had it been applied to all competing investment products. But it applies to mutual funds alone. Even real estate investment trusts investing in securities are excepted from this provision even though REITs are taxed under the provisions of Subchapter M of the Code along with mutual funds. Virtually every investment product which competes with mutual funds is unaffected. This discrimination against mutual funds and mutual fund shareholders is illogical and is objectionable tax policy. I have attached, as Attachment B, a brief analysis which illustrates the discriminatory nature of Section 67(c).

III. **SECTION 67(c) WAS INAPPROPRIATELY ADOPTED AS A TECHNICAL AMENDMENT.**

A. This Provision Was First Introduced on the Floor of the Senate Buried Among Hundreds of Technical Provisions.

I scarcely need remind the Committee that Congress is not in the habit of imputing phantom taxable income to millions of

Americans by way of technical amendment or otherwise. It should not have happened here.

Section 67 was included in the House version of the tax reform legislation and was subsequently modified by the Senate Finance Committee. However, the provision that became Section 67(c) first surfaced only in the last hours of Senate floor consideration in a ninety-page package of technical provisions. We believe that the Senate floor managers assumed that every provision in that package was purely technical, nonsubstantive. They so assured the Senate. Without debate, the Senate thereupon approved the entire package. Yet, in the end, there was Section 67(c).

B. Section 67(c) Would Never Have Survived the Deliberative Process.

I must tell you candidly that the mutual fund industry feels seriously aggrieved by last year's process. The deliberative tax reform process lasted for months. We participated actively while the tax reform bill moved through the Congress. There was never a hearing or even one minute of debate on the Senate floor about a proposal to impute phantom taxable income to mutual fund shareholders or to discriminate against mutual funds. To put it bluntly, we were denied any meaningful opportunity to oppose -- or even to comment on --Section 67(c). But the failure of the normal legislative process to work was not merely a technical infirmity -- it had serious consequences.

Had Section 67(c) ever been proposed during the Senate's deliberative process, it never would have survived. Retrospective consideration of Section 67(c) finds a conspicuous absence of support:

- Secretary Baker has written to members of Congress stating that Section 67(c) was not required for revenue neutrality last year and urging its reconsideration;
- The House Conferees last year opposed the application of Section 67(c) to mutual funds and we believe that the House Ways and Means Committee still maintains that position; and,
- Three quarters of the Senate Finance Committee members have sponsored S.1489, legislation modifying Section 67(c).

C. Section 67(c) Was a Dramatic, Substantive Change, Not a Technical Provision.

Now that the scope of Section 67(c) is understood, no one can seriously maintain that extending Section 67(c) to mutual fund shareholders generally was "technical." Section 67 of the Code is a provision which limits the deductibility of certain miscellaneous itemized deductions by individuals. Prior to the introduction of Section 67(c), mutual fund shareholders were unaffected by the debate on Section 67, because mutual fund expenses were appropriately treated as business expenses of the fund, not investment miscellaneous expenses of individuals deducted under section 212. By converting business expenses of a mutual fund into miscellaneous expenses of its individual shareholders, the introduction of Section 67(c) resulted in a dramatic, substantive change. Not only was this change inappropriate as a technical amendment, but any reasoned consideration of this change would have revealed it to be poor tax policy.

D. The Scope of Section 67(c) Was Unintentionally Broad.

The application of Section 67 to mutual funds through Section 67(c) is also not defensible as an anti-evasion device. No one would say that absent Section 67(c), 20 million mutual fund shareholders would suddenly be using their mutual funds to sidestep the restriction on Section 212 deductions. People invest in mutual funds to obtain professional investment management and diversification, not to engage in tax avoidance schemes.

S.1489 would restore the original congressional purpose of this provision. It would leave Section 67(c) intact as an anti-evasion, loophole closing provision. With regard to mutual funds, it would restrict Section 67(c)'s application to taxpayers who somehow endeavor to use a mutual fund investment to circumvent Section 67, while eliminating the need for Treasury to impose a discriminatory phantom income tax upon the vast majority of mutual fund shareholders.

IV. RELIEF FOR MUTUAL FUND SHAREHOLDERS SHOULD BE ENACTED IMMEDIATELY.

For the reasons stated above, S.1489 clearly should qualify for inclusion in the technical corrections bill. We are concerned, however, that enactment of the technical corrections bill will be delayed beyond the time when effective relief will be possible.

Retroactive relief from Section 67(c) would be costly and unmanageable. Once shareholders begin filing their 1987 tax returns in January and February of 1988, correction of Section 67(c) would be an enormous administrative burden. Moreover, the lead time required to prepare 1099 forms to be mailed next January makes immediate relief appropriate.

We, therefore, urge the Committee to enact S.1489 in the earliest available legislation.

V. REVENUE ESTIMATES ASCRIBED TO SECTION 67(c) AFTER THE FACT SHOULD NOT DETER CONGRESS FROM CORRECTING LAST YEAR'S ERROR.

A. Section 67(c) Was Introduced As a Technical Provision, Not Intended to Produce Any Revenue.

Secretary Baker has written to members of Congress that Section 67(c) was not required for revenue neutrality in last year's tax law. Indeed "technical provisions" are not supposed to yield independent revenues. We believe that no revenue was attributed to this provision either at the time it was proposed as a technical amendment on the Senate floor or at the time the President signed the bill into law.

We appreciate the Committee's concern about the revenue impact associated with various amendments to the tax law. I am sure you can appreciate our concern over the suggestion that revenue implications might prevent Congress from amending Section 67(c). Even though it is wrong as a matter of policy; was never intended to affect 20 million taxpayers; was never intended to impose a harsh competitive inequity on an industry; and was never intended to create administrative chaos for the government.

Here is a provision -- now generally disdained -- adopted only because it was proffered as a technical amendment and thus presumably not intended to produce independent revenue impact. Yet changing it may prove impossible because revenue came to be associated with it once it had been enacted? This is a Catch-22 of the highest order.

Mr. Chairman, it would be most unfortunate if technicalities of the budget estimating process were to prevent the Congress from modifying a provision that will adversely affect 20 million taxpayers. The Committee should disregard the revenue impact ostensibly associated with Section 67(c). I am not familiar with the technicalities of the budgetary process. But it makes sense to me that something introduced as a technical amendment, not designed to produce revenue, should be corrected as a technical amendment, without being saddled with revenue consequences.

B. The Revenue Attributed to Section 67(c) Should Be Reduced Under An Appropriate Construction of the Law.

While we believe that equity requires correction of Section 67(c) without consideration of any revenue impact, the whole discussion of revenue should be put in perspective. We urge the Committee to consider the following points.

Secretary Baker has written that the upward limit of revenue impact could be as much as $530 million per year. This purely theoretical figure is valid only if Treasury, in regulations, imputes 100 percent of a mutual fund's expenses as income to its shareholders. This is an unrealistic assumption that does not comport with even the most extreme construction of the law.

The legislation directed that Treasury should determine those mutual fund expenses comparable to the expenses of an individual which are subject to the two percent floor. While we do not believe that the business expenses of a mutual fund are analogous to personal miscellaneous expenses, we have, nevertheless, done our best to draw the analogy.

The mutual fund industry has presented Treasury with two analyses--one which considered the industry at large and one which actually examined the practices of eight diverse funds--to ascertain that portion of a fund's expenses which could be viewed as comparable to those individual expenses subject to the floor and, therefore, to be allocated as income to shareholders under Section 67(c). These analyses demonstrate that the appropriate percentage is no more than 22 percent.

Under these analyses, the maximum annual revenue impact associated with congressional modification of Section 67(c) would barely exceed $100 million.

C. The Revenue Estimate Should Also Be Reduced for Non-compliance, Non-collection and Other Factors.

In practical terms, even the $100 million revenue figure ought to be discounted to recognize probable shortfalls attributable to noncompliance, noncollection and other factors. Experienced tax lawyers have predicted that many taxpayers will have already prepared their tax returns on the basis of year-end statements of account prior to receiving 1099s; many will not understand the imputed income and will not pay the additional tax. The IRS will face the choice of implementing costly collection procedures or foregoing the amounts of tax at issue. In either case, the potential revenue figure associated with Section 67(c) ought to be discounted.

VI. CONCLUSION

Mr. Chairman, thank you for this opportunity to testify. The defects in Section 67(c) are readily apparent and have been broadly acknowledged. A technical correction to restore the original congressional intent -- that Section 67(c) merely prevent evasion of Section 67 -- ought to be enacted in time to provide relief to taxpayers and to mutual funds this year.

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* Shareholders in tax-exempt funds have been excluded from these statistics because it appears that such funds may be largely unaffected by Section 67(c).

ATTACHMENT A

IMPACT OF SECTION 67(c) ON OLDER SHAREHOLDERS

The significance of the fact that the numbers shown on these tables represent only average numbers may also be seen in Table 5, which illustrates the impact of section 67(c) on shareholders age 65 or older. Excluding money market fund owners, 38 percent of all mutual fund shareholders are retirees.
In general, the section 67(c) penalty falls more heavily on shareholders in this age group for three reasons. First, retirees and older individuals generally own more investments than younger individuals in the same income class. Second, elderly shareholders are less likely to be able to deduct any portion of the imputed income, because they either use the standard deduction or have insufficiant miscellaneous deductions to exceed the 2 percent floor. Most importantly, retirees and older shareholders often rely heavily on their investments for living expenses and, therefore, tend to notice any decrease in the return on their investments. The penalty imposed under section 67(c) on mutual fund investors age 65 or over is even more substantial than that imposed on younger shareholders and is, therefore, even more likely to be disturbing to these shareholders.

The impact of the section 67(c) tax penalty on the elderly may also be analyzed in terms of its effect on the tax benefits otherwise gained by the elderly under the new law. By changing the personal exemption and standard deduction amounts available to the elderly, the 1986 Tax Reform Act increased the amount of income which may be earned by an elderly couple before any tax liability is imposed. On average, at least one quarter of this benefit is offset by the section 67(c) imputed income.

Average Tax Liability on Mutual Fund Dividends and the Effect of the 67(c) Gross-Up 1/ - Shareholders 65 Years of Age and Over; All Mutual Fund Types

(1986 Levels)

Income Class (Thousands of 1986 dollars)	Tax Liability on Mutual Fund Dividends, No 67(c) Gross-up	Additional Taxable income due to 67(c) gross-up	Additional Tax liability due to 67(c) gross-up	Percentage change in taxes on mutual fund dividends due to 67(c) gross-up
less than 10	$191	$137	$ 21	10.8%
10-20	190	132	20	10.4
20-30	414	241	46	11.1
30-40	590	260	62	10.6
40-50	931	343	98	10.5
50-75	1,200	417	122	10.2
75-100	1,591	453	146	9.2
100-200	1,734	541	168	9.7
more than 200	1,747	714	201	11.5
Total	601	278	61	10.2

1/ All tax calculations are performed separately for each taxpayer within each income class. The average of the individual calculations is then computed and reported here. Therefore, the results for each income class are the average for all taxpayers within that class, including itemizers and non-itemizers, joint and non-joint filers, etc.

Source: Price Waterhouse

May 25, 1987

ATTACHMENT B

COMPETITIVE EFFECT OF SECTION 67(c)

The attached chart graphically illustrates the adverse competitive impact of section 67(c) on the mutual fund industry. For the entire spectrum of the $800 billion plus mutual fund industry, there exists one or more competing investment product which is not similarly disadvantaged. As illustrated, each major type of fund competes with other investment vehicles for the dollars of investors seeking to purchase a debt, tax-exempt debt or equity investment. Not one of these alternative investment vehicles* is burdened with the investor penalty of section 67(c).

Examples of two products which compete directly with particular sectors of the mutual fund industry are bank money market deposit accounts and managed brokerage accounts invested in equity obligations. The impact of section 67(c) on money market mutual funds and equity mutual funds may be sufficient to tip the competitive balance in favor of the non-mutual fund alternative product.

1. Money Market Funds v. Bank Money Market Deposit Accounts

At the present time, approximately one-third of all mutual fund assets, some $230 billion dollars, are invested in money market mutual funds. By contrast, the bank money market deposit accounts, a financial product created by Congress in 1983 for the express purpose of competing with money market mutual funds, currently hold some $570 billion. The yield on bank money market deposit accounts is typically set at a level very close to that paid by money market mutual funds. However, bank money market deposit accounts have the additional benefit of FDIC insurance. With the impact of section 67(c) on the effective after-tax yield on money market mutual funds, the competitive balance will, in many cases, tip clearly in favor of the bank money market deposit account.

2. Equity Mutual Funds v. Managed Brokerage Accounts

Although equity mutual funds are not typically as yield sensitive as money market mutual funds, they also have a directly competitive alternative investment product. Moreover, investors in equity mutual funds may be even more likely to be motivated than shareholders in other funds to seek out an alternative investment vehicle because of the greater impact of section 67(c) on such funds. The overall expenses of equity funds tend to be greater than those of other funds. Moreover, such funds, because they try to maximize capital appreciation rather than ordinary income dividends, typically distribute relatively small amounts of divided income. For these two reasons (higher expenses and lower ordinary income dividends), section 67(c) may be expected to have a greater impact on shareholders of equity mutual funds than shareholders of other funds. As a percentage of yield, the shareholder's pro rata share of expenses subject to the two percent floor will be greater in an equity mutual fund.

> Investors seeking an alternative investment without the tax disadvantages of equity mutual funds can establish managed equity portfolio accounts with brokerage firms. These portfolios, which typically include stocks taken from the brokerage firm's approved list can be offered to customers of the firm with no investment charge for the investment advisory services. Only brokerage commissions, which are not subject to the two percent floor, will be paid by the investor for transactions within the managed equity account.

* * * *

The essential viability of the mutual fund industry has traditionally rested upon the absence of any tax disincentive to investor in mutual funds. The mutual fund investor has been treated, for tax purposes, comparably to the direct investor in securities. Section 67(c) represents a significant departure from this basic principle. It places the mutual fund investors in a less favorable tax position than many other direct investors and thereby places funds at a considerable competitive disadvantage.

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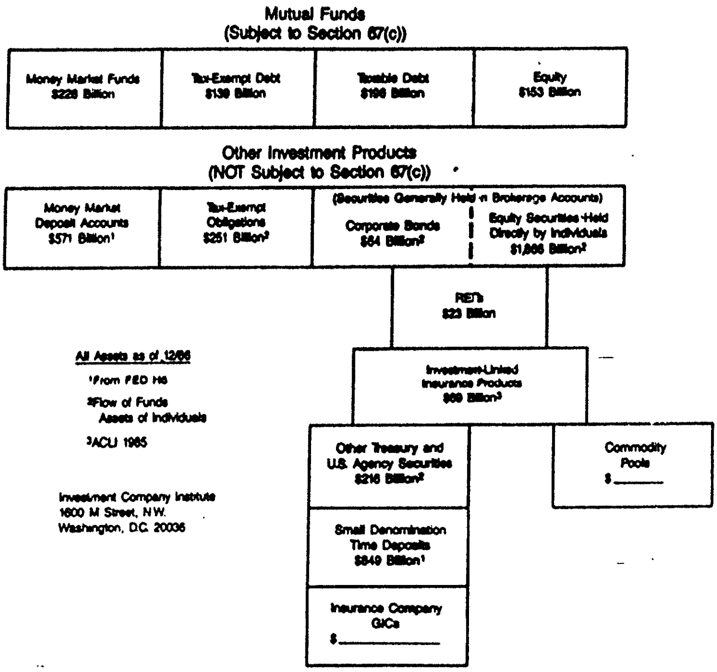
* Although it had been previously believed that commodity pools and other partnership investment products might also be affected by Section 67(c), it now appears that only mutual funds will be affected by the provision.

COMPETING INVESTMENT PRODUCTS



All Assets as of 12/86

[1] From FED H6

[2] Flow of Funds Assets of Individuals

[3] ACLI 1985

Investment Company Institute
1600 M Street, N.W.
Washington, D.C. 20036

July 22, 1987

Statement of J&B Management Company

on

S. 1350

The real estate management company J&B Management Company and its affiliated partnerships (J&B)*/ own and operate 152 multifamily housing projects in 19 different states.**/ Over half of the projects participate in HUD's rent subsidy programs, such as its Section 8 program, making J&B one of the largest owners of low-income units in the country.

J&B strongly supports Section 105(a)(10) of S. 1350. This section reiterates that the passive activities rules in the Tax Reform Act of 1986 apply to post-1986 income recognized on pre-1987 installment sales. Without this provision, Treasury's proposal to deny passive activity treatment to such income from pre-1987 installment sales will have a profoundly adverse effect on J&B's ability to continue to provide housing to low income tenants. (IRS Announcement 87-8, December 24, 1986).

Over the years J&B has, as a regular matter, sold projects to others on an installment sales basis. Often this was the only way the new owner could afford to purchase the property. Some of the income from these past installment sales will be recognized in 1987. Under current market conditions this income from past installment sales will represent the vast bulk, perhaps 80% to 90%, of J&B's 1987 total expected income. The low-income properties currently owned by J&B are generating little or no income, and most are, in fact, generating losses which in total may equal most of the income that will be recognized this year from the prior installment sales.

If Treasury's proposal to treat income from pre-1987 installment sales differently from any other kind of passive activity prevails, J&B will be required to pay tax on the income realized from the installment sales without any recognition of the losses incurred in the same year by the same taxpayer from the same type of real estate properties. This would be an extremely illogical and inequitable result. Section 105(a)(10) avoids this result, and by treating the passive income from such prior installment sales the same way as deductions generated by J&B's existing passive investments, will make it possible for J&B to offset one against the other.

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*/ This statement is submitted to the Senate Finance Committee by Mr. Bernard Rodin in his capacity as general partner of J&B Management Company.

**/ The states are Texas, Missouri, Georgia, South Carolina, Louisiana, North Carolina, Oklahoma, Florida, Kansas, New Jersey, New Mexico, Pennsylvania, Arkansas, California, Illinois, Kentucky, Maryland, Michigan, and Tennessee.

Section 105(a)(10) of S. 1350 is fully consistent with the purpose of the underlying passive activity rules, which is to prevent a taxpayer from using losses from passive activities to shelter earned income. The proposed language preserves that policy. It is also consistent with the clear meaning of the language in last year's Act. Section 469 of the new Code provides that income from one passive activity shall be deducted against passive losses from another. These passive activity rules apply to income or losses recognized in "taxable years beginning after December 31, 1986." (Section 501(c)(1) of the Reform Act). Nothing in the 1986 Act's transition provision suggests that income so recognized in taxable years beginning in 1987 from pre-1987 installment sales might be singled out for any different treatment. To the contrary, Section 501(c)(2) of the 1986 Act specifically provides that carry-overs of pre-1987 Net Operating Losses shall <u>not</u> be subject to the passive activity rules, thereby indicating that in the absence of such specific exemption, income or losses realized in 1987 from pre-1987 transactions would be subject to the same rules as any other passive income.

Enactment of Section 105(a)(10) as part of S. 1350 will, therefore, protect the original intent of the 1986 Tax Reform Act. The provision will do no more than ensure that the substantive policies Congress adopted last year are implemented in the way intended. In the absence of such provisions, the unintended and unexpected impact of the Reform Act's passive activity rules on J&B will seriously harm this company's ability to maintain its investments in low-income housing.

JOINT STATEMENT OF THOMAS A. JORGENSEN, ESQUIRE
AND ELAINE K. CHURCH
BEFORE THE COMMITTEE ON FINANCE,
U.S. SENATE

This statement is submitted jointly by Thomas A. Jorgensen, an attorney with the law firm of Calfee, Halter & Griswold in Cleveland, Ohio, and Elaine K. Church, a senior manager with the national accounting firm of Price Waterhouse. We appreciate the opportunity to provide written comments to your Committee on S. 1350, the Technical Corrections Act of 1987, and to address an important issue related to Employee Stock Ownership Plans (ESOPs).

Since 1973, Congress has supported the development and growth of ESOPs through a series of legislative initiatives. Congress viewed ESOPs as a bold and innovative method of strengthening the free enterprise system and solving the dual problems of securing capital funds necessary for corporate growth and of bringing about stock ownership for a large number of corporate employees.

The Deficit Reduction Act of 1984 further expanded the tax incentives for establishing ESOPs by adding Section 1042 to the Code. Through Section 1042, Congress sought to encourage closely-held corporations to establish ESOPs by providing certain taxpayers with the ability to defer the recognition of any gain realized on the sale of employer securities to an ESOP. To realize the Congressional intent underlying Section 1042, the Code needs to be amended.

We urge that S. 1350, now before the Committee, include a provision amending Section 409(n) of the Code to provide that the allocation restrictions be applied separately to each unrelated seller of employer securities. This would eliminate the unnecessarily punitive position taken by the Treasury Department that the allocation restrictions apply to all securities acquired by the ESOP from unrelated sellers in a Section 1042 transaction.

I. BACKGROUND

Section 1042 of the Code generally permits an individual who sells qualifying employer securities to an ESOP to defer recognition of gain realized on the sale, provided certain conditions are met. To ensure that the transaction actually benefits a broad group of employees, Section 1042(b), as originally enacted, denied nonrecognition treatment if the ESOP allocated securities acquired in a Section 1042 transaction to or for the benefit of (1) the seller, (2) certain family members of the seller, or (3) any 25 percent shareholder.

Because of the three-year statute of limitations typically applicable to an individual's tax return, it was determined that denying Section 1042 nonrecognition treatment to the seller was an ineffective sanction. Once the statute had expired with respect to the seller's return, no enforceable penalty would apply if the ESOP allocated the Section 1042 securities to the prohibited participants. To remedy this situation, the Tax Reform Act of 1986 (the "Act") replaced Section 1042(b) with new Section 409(n). Section 409(n) generally provides that an allocation of Section 1042 securities to prohibited individuals will (1) be treated as a distribution to these individuals and (2) be subject to the 50 percent excise tax imposed by Section 4979A.

II. INTERPRETATIONS OF THE ALLOCATION RESTRICTIONS PRIOR TO THE TAX REFORM ACT OF 1986

The scope of these restrictions on the allocation of securities acquired in a Section 1042 transaction has never been clearly articulated. Section 1042(b)(3) originally restricted allocations of "assets...attributable to employer securities... acquired by the plan described in paragraph (1) [of Section

1042]." This language, which was not addressed in the Senate Finance Committee Report (S. Rep. 98-169, 98th Cong. 2nd Sess. 1183), arguably would have totally precluded prohibited individuals from participating in an ESOP that is a party to a Section 1042 transaction (including participation in a pretransaction period). However, the General Explanation of the Deficit Reduction Act of 1984 suggests that this prohibition was not intended. The General Explanation states, at page 897, that the allocation restrictions extend merely to "assets attributable to the qualified securities involved in the nonrecognition transaction." Thus, where the allocation restrictions would apply to the seller and family members, they appeared merely to restrict the allocation of the securities acquired from the seller in the Section 1042 transaction.

The General Explanation appeared also to suggest, therefore, that if there were a series of Section 1042 transactions involving unrelated sellers, the allocation restrictions would apply separately to the securities acquired in each transaction. Assume, for example, that in two Section 1042 transactions involving unrelated sellers, the allocation restrictions would apply separately to the securities acquired in each transaction. Assume also that $15 million of securities are acquired from Seller A in year one and $1 million of securities from Seller B in year three. Assume further that A and B are unrelated and that A, B and their family members are not twenty-five percent shareholders. In that case, the General Explanation suggests that Seller A (and family) are precluded from receiving an allocation of any of the $15 million of securities acquired in the sale by A, but are eligible to participate in the allocation of the $1 million of securities in the sale by B. Similarly, B (and family) are precluded from receiving an allocation of any of the $1 million of securities acquired in the sale by B, but are eligible to participate in the allocations of the securities acquired in the sale by A.

The Treasury Department, however, took a contrary view in temporary regulations issued under Section 1042. Question and Answer 2 of Section 1.1042-1T provides that the allocation restrictions apply to every seller and family member with respect to all securities acquired in any sale (either concurrent or subsequent) to which Section 1042 applies. Under this interpretation, A (and family) could not participate in the allocation of the securities acquired from either A or B. Also, although B (and family) could participate in year one and year two allocations of securities acquired from A, they could not, by virtue of B's sale in year three, thereafter participate in further allocations of securities acquired from A. We believe this position is unnecessarily punitive.

III. THE TAX REFORM ACT OF 1986

When the Act altered the sanctions for allocating securities to restricted individuals, the issue of the scope of the allocation restrictions resurfaced. By its terms, Section 409(n) now generally restricts the allocation of "securities acquired by the plan...in a sale to which Section 1042...applies." Also, Section 409(n)(3) provides a limited exception to the allocation restrictions for individuals otherwise affected only because they are a seller's lineal descendants. Under the exception -- "the aggregate amount allocated to the benefit of all such lineal descendants during the nonallocation period cannot exceed more than five percent of the employer securities (or amounts allocated in lieu thereof) held by the plan which are attributable to a sale to the plan by any person related to such descendants (within the meaning of Section 267(c)(4)) in a transaction to which Section 1042 applied." We understand that except for the addition of the rules under Section 409(n)(3), the Act's replacing the sanctions under Section 1042(b) with those under Section 409(n) was not intended to alter the scope and application of the allocation restrictions.

The limited exception in Section 409(n)(3) does not, of course, necessarily invalidate the temporary regulations but it does call their validity into question. Section 409(n)(3) was intended as a relief provision to allow lineal descendants to share in some portion of the securities acquired from a related party. It seems unusual for Congress to allow descendants to share in allocations from a related party if they are precluded from receiving allocations from strangers. If the proposed regulations are still valid, A (and family) generally would be precluded from receiving any securities received from A or B except that, pursuant to Section 409(n)(3), A's lineal descendants could receive allocations of securities received from A or B in an amount not to exceed five percent of the $15 million of securities acquired from A. B (and family) could continue to participate in allocations of securities received from A in year one or year two. However, in year three, further allocations of A's securities (and all allocations of B's securities) to A (and family) and B (and family) generally would be precluded on account of B's sale, except that, pursuant to Section 409(n)(3), B's lineal descendants could receive allocations not to exceed five percent of the $1 million acquired from B.

We believe that this result, like that suggested by the temporary regulations, seems unduly punitive. If A and B are unrelated, it is unnecessary to preclude A (and family) from receiving allocations of securities acquired from B or to preclude B (and family) from receiving allocations of securities acquired from A. Also, it makes little sense to allow A's lineal descendants to receive allocations of securities acquired from A or B not to exceed five percent of the securities acquired from A and no other securities acquired from B.

IV. REASONS THAT THE ALLOCATION RESTRICTIONS MUST BE AMENDED

The allocation restrictions were orginally intended to preclude inappropriate tax benefits to individuals who merely changed the form of their stock ownership. Thus, for example, an individual who sells securities to an ESOP was ineligible to defer recognition of gain if those securities were then reallocated to the individual under the ESOP. This intent is not furthered by applying the allocation restrictions to separate transactions involving unrelated parties and disparate amounts. Moreover, the severity of the sanction varies indirectly with the size of the Section 1042 transaction. Thus, those taxpayers deriving the greatest tax benefit are subject to the least sanction. In our example, for instance, denying B (and family) the opportunity to share in plan allocations of the $15 million acquired from A is not warranted by the nonrecognition treatment afforded B with respect to B's subsequent sale of only $1 million of securites. In addition, application of the allocation restrictions in this fashion operates as a trap for the unwary. If, for example, B had delayed the sale of the $1 million until the $15 million of securities acquired from A were fully allocated, B (and family) clearly could share in the allocation of securities acquired from A. It is only because B engaged in a Section 1042 transaction before the securities acquired from A were fully allocated, that the restrictions apply to B (and family). This different result is not compelled by the timing difference.

The results are similarly skewed if the ESOP borrows to acquire securities in a Section 1042 transaction. In such a leveraged transaction, the acquired securities are allocated as the debt is repaid. Thus, in our example, if the ESOP were not leveraged and securities acquired from A were fully allocated prior to B's sale, B (and family) could participate in all allocations of such securities. If, however, the ESOP were leveraged so that debt repayment and allocations of the securities acquired from A continued after the plan acquired securities from B, B (and family) would be precluded from receiving allocations of securities acquired from A during the nonallocation period beginning with the date the plan acquired securities from B.

We understand that the position taken in the temporary regulations is due, in large part, to concerns about "cross-allocations" where two shareholders agree to simultaneously sell their securities to an ESOP. Although shareholder A (and family) would be precluded from receiving allocations of securities acquired from A, some have argued that this restriction has no effect if they can receive allocations of securities acquired from B. This analysis seems overly simplistic. Even if A and B simultaneously sold equal amounts to the ESOP and were the only ESOP participants, applying the restrictions separately to each prohibited individual would limit each individual to an allocation equal to one-half of the allocation to which he or she would otherwise be entitled under the plan. This hardly represents a negation of the allocation restrictions. Where, as is more often the case, the shareholders sell different amounts to the ESOP at different times, and there are many completely unrelated participants in the ESOP, the position taken in the temporary regulations is even less justified.

We do recognize that in rare cases there could be cross-allocations among sellers engaging in a Section 1042 transaction. This could occur, for example, if a corporation were owned by four shareholders, each of whom had a twenty-five percent interest and all four fold their entire interests to an ESOP which covered only those four individuals. In this example, we concede that, absent the restrictive position taken in the temporary regulations, each shareholder could receive ESOP allocations of twenty-five percent. Thus, in effect, each shareholder would retain his or her aggregate holdings while still enjoying the tax benefits provided by Section 1042. While we agree that this example shows that impermissible cross-allocations could occur, it is important to note that this would be a very rare situation. Attempts to preclude this abuse should not make the general rules unduly restrictive. This potential abuse would be better limited by rules that focus attention on the abusive situation. For example, the statute could preclude cross-allocation or, like Section 412(c), permit limited allocations to lineal descendants only if no more than one-third of aggregate allocations benefit highly-compensated employees.

V. CONCLUSION

For these reasons, we believe that S. 1350 should include a provision amending Section 409(n) to provide that the allocation restrictions apply separately with respect to each unrelated seller of employer securities. This would permit A (and family) to fully participate in allocations of the $1 million of securities acquired from B and, pursuant to Section 409(n)(3), A's lineal descendants could also receive allocations of as much as five percent of the $15 million of securities acquired from A. Similarly, B (and family) would be permitted to participate fully in allocations of the $15 million of securities acquired from A and B's lineal descendants could also receive allocations of as much as five percent of the $1 million of securities acquired from B.

STUART R. JOSEPHS
6408 CRYSTALAIRE DRIVE
SAN DIEGO, CALIFORNIA 92120-3834

July 14, 1987

Ms. Laura Wilcox
Hearing Administrator
United States Senate
Committee on Finance
Room SD-205
Washington, D.C. 20510

Re: 1987 Technical Corrections Bill (S. 1350)

Dear Ms. McAuliffe:

Section 102(a) of the 1986 Tax Reform Act amended Section 63 of the 1986 Internal Revenue Code to provide that, in the case of an individual for whom a personal exemption deduction is allowable on another taxpayer's return, the individual's standard deduction is limited to the greater of $500 or the individual's earned income. This limitation causes two taxpayers with the same amount of unearned income to be treated differently if one of them also has earned income.

If this unfair result is unintended, Code Section 63(c)(5) should be corrected to limit the standard deduction in this situation to the greater of--

(A) $500, or

(B) the individual's earned income <u>plus $500</u>. (Suggested correction underscored.)

Respectfully,

Stuart R. Josephs

Stuart R. Josephs, CPA
(619) 469-6999

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July 23, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D. C. 20510

Re: Proposed Technical Correction to Code Section 57(a)(3)

Dear Ms. Wilcox:

I have attached five copies of written comments we are filing on behalf of COMPAQ Computer Corporation regarding a proposed revision to the rule in section 57(a)(3) of the Internal Revenue Code of 1986 requiring current inclusion in alternative minimum taxable income of the spread between fair market value and exercise price of stock acquired on exercise of an incentive stock option. A summary of the recommendation is also enclosed.

The proposed revision would deal with the problem that results when a taxpayer who wishes to make a disqualifying disposition of stock acquired on exercise of an incentive stock option (resulting in ordinary income to the taxpayer) is prevented from doing so due to the operation of section 16(b) of the Securities and Exchange Act of 1934. The suggested revision would amend section 57(a)(3) to provide that the spread between fair market value and exercise price of stock acquired on exercise of an incentive stock option will not be included in alternative minimum taxable income for the taxable year of exercise if the stock is disposed of in a disqualifying disposition either (i) on or before the last day of the taxable year of exercise or (ii) in the case of stock that is subject to section 16(b) of the Securities and Exchange Act of 1934, on or before the 120th day following the lapse of the period during which the sale of such stock at a profit could subject the taxpayer to suit under that Act.

I would like the opportunity to visit with Senate Finance Committee staff regarding the proposed revision to section 57(a)(3), and I will of course be happy to answer any questions staff may have about the proposal at that meeting.

Very truly yours,

David G. Glickman

COMPAQ COMPUTER CORPORATION

PROPOSED REVISION OF RULES REQUIRING INCLUSION OF
INCENTIVE STOCK OPTION
SPREAD IN ALTERNATIVE MINIMUM TAXABLE INCOME
FOR TAXABLE YEAR OF EXERCISE

Section 57(a)(3) of the Internal Revenue Code of 1986 (the "Code") requires the spread between value and exercise price of stock received on exercise of an incentive stock option ("ISO") to be included in income for alternative minimum tax ("AMT") purposes at the time of exercise. The General Explanation of the Tax Reform Act of 1986 states that the spread on exercise was intended to constitute an item of tax preference even if the stock is later the subject of an early, or "disqualifying," disposition. Prior to the enactment of the Tax Reform Act of 1986, the ISO spread on exercise was not subject to inclusion in income for AMT purposes if the ISO stock was later the subject of an early disposition, because the early disposition caused the spread to be taxed as ordinary income. Section 57(a)(3) of the Code should continue to exclude the ISO spread on exercise from income for AMT purposes in those cases in which an early disposition is made either on or before the close of the taxable year of exercise, or after the taxable year of exercise where the sole reason for the delay in disposition is due to the application to the taxpayer of section 16(b) of the Securities and Exchange Act of 1934 (the "Exchange Act").

The ISO preference item was included as an item of tax preference income because the spread on exercise is deferred income recognized for regular tax purposes when a disposition of the ISO stock is later made. Generally, all such "deferred" items are elective, meaning the taxpayer could avoid inclusion of the item (or an adjustment to taxable income) for AMT purposes by simply not availing himself or herself of the tax deferral. Clearly, no deferral is enjoyed by a taxpayer who makes an early disposition of stock on or before the close of the taxable year of exercise; thus, such a taxpayer should not be required to incur the time and expense of computing the ISO spread on the exercise date, including that spread in income for AMT purposes, and determining whether regular tax or AMT should be the basis for making estimated tax payments.

In addition, in the case of a taxpayer who is subject to section 16(b) of the Exchange Act, exercise of an ISO within six months prior to the end of the taxable year of exercise will not permit a taxpayer who wishes to make a disqualifying disposition to do so before the end of such taxable year because such a sale would cause the loss of the taxpayer's economic profit by operation of section 16(b) of the Exchange Act. Such a taxpayer must wait until after the lapse of the 16(b) six-month holding period, and thus must sell the option shares after the close of the taxable year of exercise. Since this deferral is not elective, but rather is compelled by the operation of a non- tax federal statute, this deferral should not be subject to the AMT.

Accordingly, section 57(a)(3) of the Code should be amended so that the ISO spread is not an item of tax preference for the year of exercise by a taxpayer if the shares purchased on exercise of the ISO are either (a) disposed of by the taxpayer in a disqualifying disposition on or before the close of the taxable year of exercise, or (b) subject to the provisions of section 16(b) of the Exchange Act in the hands of the taxpayer and are disposed of by the taxpayer in a disqualifying disposition within 120 days after the lapse of the section 16(b) holding period applicable with respect to such shares. The 120-day grace period for sale is required because internal corporate policy generally prevents executives who are "insiders" and who have exercised ISOs from selling the option stock until the quarterly earnings reports of their corporate employer have been released, and the 120-day period will give such an executive approximately 30 to 60 days from such release to consider the economic issues involved in a decision to sell or not sell option stock.

The relief sought for taxpayers subject to section 16(b) of the Exchange Act is similar to the relief granted such taxpayers in Public Law Number 97-34, Section 252(a), which added section 83(c)(3) to the Code. This provision, by treating stock as subject to a substantial risk of forfeiture during the period it is subject to section 16(b) of the Exchange Act, permitted taxpayers to defer recognition of income by reason of their receipt of such stock for services until they were able to sell the stock and obtain cash to pay the tax. Similarly, by not requiring the inclusion in income for AMT purposes of stock received on exercise of an ISO until after the taxpayer is able to sell the stock and obtain cash to pay the tax, the relief sought advances the laudable policy of not requiring taxpayers to incur tax liability with respect to appreciation in property before they have converted the appreciated property into cash that enables them to pay the tax. In addition, such a result will eliminate underpayment of estimated tax penalties for individuals who for some reason cannot pay estimated tax on this AMT preference until the option stock is sold. Accordingly, COMPAQ Computer urges the careful consideration of the attached proposed amendment to section 57(a)(3) of the Code.

PROPOSED AMENDMENT TO CODE SECTION 57(a)(3)

Section 57(a)(3) of the Internal Revenue Code of 1986 would be amended to read as follows:

(3) INCENTIVE STOCK OPTIONS.--

(A) IN GENERAL. - <u>Except as otherwise provided in subparagraph (B)</u>, with respect to a transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in section 422A, <u>whether or not the holding period requirements of section 422A(a)(1) are met</u>), the amount by which the fair market value of the share at the time of exercise exceeds the option price. For purposes of this paragraph, the fair market value of a share of stock should be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.

(B) <u>CERTAIN DISQUALIFYING DISPOSITIONS. - Subparagraph (A) shall not apply to a share of stock that is disposed of prior to the lapse of the period specified in paragraph (1) of subsection (a) of section 422A if</u>

<u>(i) the disposition occurs on or before the last day of the taxable year in which the share of stock is transferred to the taxpayer pursuant to the exercise of the incentive stock option, or</u>

<u>(ii) in the case of a share of stock transferred on exercise of an incentive stock option to a taxpayer subject to section 16(b) of the Securities and Exchange Act of 1934, the disposition occurs on or before the 120th day following the last day of the period during which the sale of the share at a profit could subject the taxpayer to suit under section 16(b) of the Securities and Exchange Act of 1934.</u>

(C) BASIS ADJUSTMENT. - In determining the amount of gain or loss recognized for purposes of this part on any disposition of a share of stock acquired pursuant to an exercise (in a taxable year beginning after December 31, 1986) of an incentive stock option, the basis of such stock shall be increased by the amount (if any) of the excess referred to in subparagraph (A) that constitutes an item of tax preference.

COMPAQ COMPUTER CORPORATION

SUMMARY OF SUGGESTED REVISION OF RULES REQUIRING INCLUSION OF INCENTIVE STOCK OPTION SPREAD IN ALTERNATIVE MINIMUM TAXABLE INCOME FOR TAXABLE YEAR OF EXERCISE

Section 57(a)(3) currently requires the spread between fair market value and exercise price of stock acquired on exercise of an incentive stock option to be included in alternative minimum taxable income in the taxable year of exercise. In the case of a taxpayer who makes a disqualifying disposition of such stock (resulting in ordinary income to that taxpayer) but who, due to the operation of section 16(b) of the Securities Exchange Act of 1934, cannot make the disqualifying disposition until after the close of the taxable year of exercise, inclusion of the spread in alternative minimum taxable income in effect penalizes the taxpayer for a deferral that is not within his or her control. Such an inclusion may require the taxpayer to make estimated alternative minimum tax payments before the taxpayer is able to sell the stock and obtain cash to pay such tax, or face estimated tax underpayment penalties. Such inclusion also unfairly requires the taxpayer to undertake both regular tax computations and alternative minimum tax computations, both for estimated tax purposes and for purposes of preparing his or her return, thereby causing the taxpayer to incur additional time and expense merely because a non-tax federal statute prevents the taxpayer from selling the stock in the taxable year of exercise.

Such penalties should not be imposed on a taxpayer who has not voluntarily elected to defer the sale of incentive stock option stock. Accordingly, section 57(a)(3) of the Internal Revenue Code of 1986 should be amended to provide that the spread between fair market value and exercise price of stock acquired on exercise of an incentive stock option will not be included in alternative minimum taxable income for the taxable year of exercise if such stock is disposed of in a disqualifying disposition either (i) on or before the last day of the taxable year of exercise or (ii) in the case of stock that is subject to section 16(b) of the Securities and Exchange Act of 1934, on or before the 120th day following the lapse of the period during which the sale of such stock at a profit could subject the taxpayer to suit under that Act. A 120-day "grace" period for sale following lapse of the section 16(b) restrictions is particularly appropriate because internal corporate policy normally limits the ability of executives to sell stock until after quarterly earnings reports are released to the public, and a 120-day period will give such an executive who is an "insider" approximately 30 to 60 days following the released earnings reports to consider the economic issues involved in a decision to sell or not sell option stocks.

Designated Representative of COMPAQ Computer Corporation:

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WESLEY J.A. JONES

..Charitable Gift Planning
..Asset Management
..Private Trustee

33 West Lancaster Drive
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June 29, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington DC 20510

Dear Ms. Wilcox:

As planned giving counsel to tax-exempt organizations located in several states, I urge consideration of amending the Technical Corrections Act of 1987 (H.R. 2636) so that charitable gift annuities are not construed as "commercial-type insurance" and therefore not subject to IRC Sec. 501(m) as enacted by TRA '86.

For H.R. 2636 to remain silent on this point, IRC Sec. 501(m) could be misinterpreted and thereby subject 501(c) (3) organizations to tax on their gift annuities like commercial annuities issued by insurance companies.

Such amendment should clearly distinguish charitable gift annuities from "commercial-type insurance" for the following reasons:

(1) Charitable gift annuities are not "commercial" in type or purpose and do not compete with commercial annuities.

(2) Charitable gift annuities are sought by donor/constituents of charitable organizations primarily because of those individuals' intent to make a charitable gift rather than to enhance personal income.

(3) Failure to clarify the law could extinguish an important source of charitable funds from small donors for whom it is not practical to undertake a charitable remainder annuity trust which is more feasibly utilized by large donors. The latter instrument is not affected by IRC Sec. 501(m).

Your earnest consideration of this position and receipt of your views on the subject would be appreciated.

Sincerely,

Wesley J.A. Jones

Wesley J.A. Jones

M E M O R A N D U M

SECTION 114(g)(2)(D) OF THE TECHNICAL CORRECTIONS ACT OF 1987
SHOULD BE DELETED FROM THE LEGISLATION BECAUSE IT WOULD
IMPLEMENT A CHANGE IN THE TAX REFORM ACT OF 1986
WHICH IS BOTH NON-TECHNICAL AND UNFAIR

I. Introduction.

Section 114(g)(2)(D) of S. 1350, the Technical Corrections Act of 1987 should be deleted because it would implement a change in the Tax Reform Act of 1986 (the "1986 Act") which is not technical, which constitutes unsound tax policy, and would penalize individuals who are incapable of responding to this proposed change. Under this change, the new version of the generation-skipping transfer tax (the "GST") enacted under the Tax Reform Act of 1986 would unfairly apply to transfers upon death by persons who became incompetent after September 25, 1985, and prior to the date of enactment on October 22, 1986 -- an advance in the effective date of more than 1 year. This change should be deleted.

II. A Variety of Independent and Separate Reasons Support the Deletion of Section 114(g)(2)(D).

A. Section 114(g)(2)(D) is Clearly Not a Technical Change in the 1986 Act.

Section 114(g)(2)(D) clearly does not constitute a technical correction to the 1986 Act. The statutory language of section 1433 of the 1986 Act contains no ambiguity or lack of clarity. It unequivocally indicates that post-death transfers by persons who were incompetent on the date of enactment are not subject to the amended form of the GST.

> SEC.1433.EFFECTIVE DATES.
>
> (a)GENERAL RULE.-Except as provided in subsection (b), the amendments made by this part shall apply to any generation-skipping transfer (within the meaning of section 2611 of the Internal Revenue Code of 1986) made after the date of the enactment of this Act.
>
> * * *
>
> (b)SPECIAL RULES.-
>
> * * *
>
> (2)EXCEPTIONS.-The amendments made by this part shall not apply to-
>
> * * *

(C)any generation-skipping transfer-

(i)under a trust to the extent such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after the date of the enactment of this Act), or reinvestments thereof, or

(ii)which is a direct skip which occurs by reason of the death of any decedent;

but only if such decedent was, on the date of the enactment of this Act, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death. (Emphasis added.)

The House bill equivalent of section 1433(b)(2) of the 1986 Act as it relates to incompetent persons is identical to the language contained in the enacted version. It states as follows:

SEC.1223.EFFECTIVE DATES.

(a)GENERAL RULE.-Except as provided in subsection (b), the amendments made by this part shall apply to any generation-skipping transfer (within the meaning of section 2611 of the Internal Revenue Code of 1985) made after the date of the enactment of this Act.

(b)SPECIAL RULES.-

*   *   *

(2)EXCEPTIONS.-The amendments made by this part shall not apply to-

*   *   *

(B)any generation-skipping transfer-

(i)under a trust to the extent such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after the date of the enactment of this Act), or reinvestments thereof, or

(ii)which is a direct skip which occurs by reason of the death of any decedent;

but only if such decedent was, on the date of the enactment of this Act, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death. (Emphasis Added.)

The Senate version of the 1986 Act contained no provision dealing with the GST. As a consequence, the Senate bill provides no guidance on this matter.

While it is true that the Ways and Means Committee Report language and the Joint Explanatory Statement of the Committee of Conference of the 1986 Act incorrectly describe September 25, 1985, as the relevant statutory date for purposes of the GST incompetency provision, justifying section 114(g)(2)(D) based on these reports is inappropriate because both the House version of the statute and the enacted version are clear and unambiguous on their face. The House report language and the Conference Report language simply represent a mistake in description of the statutory language adopted respectively by the House bill drafters and the Conference on the 1986 Act. This is demonstrated by the General Explanation of the Tax Reform Act of 1986 Joint Committee on Taxation (May 4, 1987) (hereinafter referred to as the "Blue Book") which correctly describes the enacted version of section 1433 of the 1986 Act.

EFFECTIVE DATES

> The amended generation-skipping transfer tax applies to transfers after the date of enactment (October 22, 1986), subject to the following exceptions:
>
> * * *
>
> (4)Transfers under a trust to the extent that such trust consists of property included in the gross estate of the decedent or which are direct skips which occur by reason of the death of any decedent if the decedent was incompetent on the date of this Act (October 22, 1986) and at all times thereafter until death. Blue Book at 1267.

In contrast to numerous other instances throughout the Blue Book, including in the discussion of the GST, there is no indication in the description of the effective date in the Blue Book that the enacted statute is in any way inconsistent with the intended rule nor that a technical correction is contemplated. This confirms the conclusion that the reference in the House Report and Conference Report to the September 25 date was in error, and was not an intended policy overriding the clear language of the House bill and the enacted statute.

B. <u>Section 114(g)(2)(D) Substantively Represents Unsound Tax Policy Given the Context in Which the Repeal of the 1976 Version of GST has been Considered</u>.

Independent of the apparent non-technical status of section 114(g)(2)(D), its substantive content lacks a basis in sound tax policy, particularly given the history surrounding the repeal of the 1976 version of the GST and its replacement with the version enacted as part of the 1986 Act. Virtually from the moment that the 1976 version of the GST was enacted it was soundly criticized by virtually all informed tax professionals and professional trust administrators as unworkable, incomprehensible and unfair. It became quite clear in the early 1980's that the 1976 version of the GST would be repealed outright or that it would be replaced by a substantially different tax.

The U.S. Treasury Department during the early 1980's offered a number of proposals for addressing the problems with the 1976 version of the GST. In each case, these proposals recognized that sound tax policy dictated the inclusion of ample transition relief in recognition of the level of confusion which had been created through the enactment of the 1976 version.

For example, in testimony delivered on June 27, 1983, to the Subcommittee on Estate and Gift Taxation of the Senate Finance Committee by then acting Tax Legislative Counsel of the Department of Treasury Robert G. Woodward, the Treasury proposed the following effective date provision:

> In general, the GST tax imposed under this proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal, and to all direct generation-skipping transfers made on or after that date. The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts of decedents dying before the date which is one year from the date of enactment. <u>The effective date would be extended for testators who are incompetent on the date of enactment</u>. This one-year

> transition rule will give estate planners time to understand the new rules and to adjust their planning accordingly. "Statement of Robert G. Woodward Acting Tax Legislative Counsel, Department of the Treasury, Before the Subcommittee on Estate and Gift Taxation of the Senate Finance Committee" (June 27, 1983) at 15. (Emphasis added.)

The Treasury proposed this version of the effective date because "legislative uncertainty has made estate planning in this area difficult," Woodward Testimony at 10, a statement which most practitioners would view as containing a significant degree of understatement.

The Treasury's study on tax reform which was submitted to the President in December 1984 and which served as the basis for the provision enacted in the 1986 Act also recognized the need for ample effective date provisions. This legislative uncertainty had been generated by numerous generation skipping transfer proposals including Senate action on several occasions to repeal entirely the 1976 GST. Recognizing this uncertainty and consistent with its earlier proposals, the Treasury proposed the following effective date provision:

> In general, the GST tax imposed under this proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal, and to all direct generation-skipping transfers made on or after that date. <u>The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts or decedents dying before the date which is one year from the date of enactment</u>. <u>The effective date would be extended for testators who are incompetent on the date of enactment</u>. This one-year transition rule would give estate planners time to understand the new rules and to adjust their planning accordingly. <u>Tax Reform for Fairness, Simplicity, and Economic Growth Volume 2</u>, Office of the Secretary, Department of the Treasury (November 1984) at 391. (Emphasis added.)

The policy of the Treasury consistently advanced with respect to the effective date provisions of the GST, generally and specifically with respect to individuals incompetent on date of enactment, reflects sound tax policy judgments which are consistent with the complete uncertainty which surrounded this issue for over 10 years and the massive complexity of this area of law. The policy of the effective date provisions advanced by the Treasury and enacted in the 1986 Act should not be altered through the technical corrections process.

An earlier effective date provision not only ignores the confusion and uncertainty that handicaps proper planning, it also fails to provide any positive policy benefit to justify its negative impact. When new tax laws are applied to steps taken prior to the date of enactment, it is usually justified as a means of preventing "windows of opportunity" for tax avoidance by pre-enactment planning. That purpose is not served by the change now being proposed to the effective date. In the first instance, the change is being suggested (without prior announcement) a full nine months after enactment. More importantly, taxpayers simply do not plan to become incompetent to avoid an oncoming tax.

In fact, if any change should be contemplated with respect to incompetent individuals, it should be to conform their treatment to that afforded individuals who have died, because incompetency represents the equivalent of death so far as the ability to modify an individual's estate plan is concerned. The 1986 Act provides that individuals that die before January 1, 1987, are exempt from the GST. The technical corrections legislation would not modify this change. Since incompetency effectively prevents a taxpayer from modifying his or her estate plan in any manner, it would seem appropriate to provide treatment for individuals becoming incompetent prior to January 1, 1987, as comparable to a death which occurs prior to that date.

C. <u>Individuals who Became Incompetent After September 25, 1985, and Before the Date of Enactment Would be Unfairly Penalized by Section 114(g)(2)(D)</u>.

Individuals who became incompetent after September 25, 1985, and before the date of enactment of the 1986 Act (October 22, 1986) would be unfairly penalized if section 114(g)(2)(D) were enacted. These individuals, by definition, are now incapable of modifying their estate plans in light of the newly enacted version of the GST.* Some of these individuals may have already died. Between September 25, 1985, and October 22, 1986, persons had a right to rely on the effective date provisions in the proposed bill which clearly provided that there would be no retroactive effective date except as to inter-vivos irrevocable transfers. Logically, persons did not have to change their wills and trust documents until the date of enactment or after, thus allowing their tax advisers to wait to look at the final version of the act. Even a person who feared incompetence had no reason to act otherwise because the provisions of the bill with respect to incompetence also were not retroactive. However, under the technical

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* The implied instruction of section 114(g)(2)(D) is that a person fearing incompetence should have changed his or her estate plan merely on the basis of provisions of a Bill introduced only in the House of Representatives and not yet even approved by the Ways and Means Committee and whose clearly stated effective date was delayed. This is unreasonable. Even if this instruction could be discerned, how could it be carried out intelligently? The character of the new statute was not firmly established let alone understood by professionals. It is important to keep in mind that the Senate Bill contained no GST provisions at all, and it was entirely unclear whether any GST proposal would be included in the final bill until after the Confernce Committee made its report in October of 1986. In fact, given the pending technical corrections legislation, it is fair to say that the nature of the GST provisions cannot be understood with any certainty even today.

corrections bill, people who in fact became incompetent and unable to change their estate plans, would lose the protection of the transitional rules after the fact. This is clearly unfair. Another way of viewing the problem is that a taxpayer who died during the transition period (September 25, 1985, through December 31, 1986) is protected; a person who survived and remained competent is able to react and change his or her plan; but a person who became incompetent is denied either chance. These types of concerns obviously caused Treasury drafters of the various post-1976 Act revisions to the GST to provide ample transition relief for incompetent individuals. The merit of this policy position should not be reversed through technical correction legislation which fundamentally alters the statutory effective date provision included in the 1986 Act.

III. Conclusion.

Section 114(g)(2)(D) clearly represents a substantive change to the statutory provision contained in the 1986 Act. By moving the effective date of the 1986 GST for incompetent persons, fundamental inequities would be imposed on individuals who are obviously incapable of responding to such a legislative change. The obvious and apparent unfairness of such a measure is inconsistent with sound tax policy. As a consequence, section 114(g)(2)(D) should not be included as part of any technical correction legislation.

SUPPLEMENTAL SHEET SUMMARIZING TESTIMONY

Section 114(g)(2)(D) of S. 1350, the Technical Corrections Act of 1987 would substantively amend section 1433(b)(2)(C) of the Tax Reform Act of 1986 (the "1986 Act") by advancing by over a year the effective date of the generation skipping transfer tax as it relates to incompetent persons. This change is not technical, constitutes unsound tax policy and should be deleted from technical corrections legislation. The designated representative listed below represents Alex Miller, an individual who became incompetent after September 25, 1985, but before the date of enactment of the 1986 Act. Section 114(g)(2)(D) would unfairly impact this individual who lacks now the ability to modify his estate plan in response to the provisions enacted as part of the 1986 Act or to changes like that now proposed by the technical corrections legislation. The obvious unfairness which section 114(g)(2)(D) would impose on Alex Miller and other individuals like him dictates that this provision be deleted from technical correction legislation. The designated representative of Alex Miller for this matter is as follows:

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WRITER'S DIRECT DIAL NUMBER

July 23, 1987

U. S. Senate Committee on Finance
Room SD - 205
Dirksen Senate Office Building
Washington, DC 20510

Dear Sirs and Mesdames:

The purpose of this letter is to comment on Section 107(c)(4) of the Technical Corrections Act of 1987 (the "Act") which would require that the exercise of an Incentive Stock Option ("ISO") be treated as a tax preference notwithstanding that the stock so acquired is disposed of later in a disqualifying disposition. The change proposed by Section 107(c)(4) is much more than a technical correction to the Tax Reform Act of 1986 ("Reform Act"); it is a significant and substantive change in the Reform Act's application of the alternative minimum tax to ISOs.

Presently, under Section 57 of the Internal Revenue Code of 1986 ("Code"), as amended by the Reform Act, any transfer of a share of stock pursuant to an exercise of an ISO (as defined in Code Section 422SA) is treated as a tax preference. However, as defined in Section 422A, the ISO tax preference does not apply if the stock so acquired is disposed of in a disqualifying disposition. Thus, the Act makes a substantive change in the Code, as amended by the Reform Act, by applying the ISO tax preference to stocks disposed of in a disqualifying disposition.

The proposed change is unfair to taxpayers in two respects. First, applying the ISO tax preference to stocks disposed of in a disqualifying disposition unduly punishes those taxpayers who must transfer their shares before the expiration of the requisite holding period. Second, a retrospective application of Act Section 107(c)(4) is unfair to the taxpayers who have relied on the present law in making decisions concerning ISOs.

Section 107(c)(4) of the Act would punish those taxpayers who dispose of their shares in a disqualifying disposition by making them bear the burden of a tax preference even though they have foregone the beneficial tax treatment of the ISO. For example, under the Tax Reform Act, a taxpayer who sells his ISO shares in a disqualifying disposition realizes ordinary income in the year of the sale in an amount equal to the excess of the selling price over the exercise price ("the ISO spread"). However, the ISO spread does not constitute a preference item for the purposes of the alternative minimum tax. In contrast, under the Act, the same taxpayer will not only realize ordinary income in the year of the sale, but will also add an ISO tax preference (measured by the excess of fair market value at the time of exercise over the option price) to his adjusted gross income for the purpose of calculating the alternative minimum tax. Thus, a taxpayer who sells his ISO stock in a disqualifying disposition will realize an ISO tax preference, even though he is getting none of the tax benefits of an ISO.

The General Explanation of the Tax Reform Act of 1986 ("General Explanation"), prepared by the Staff of Joint Committee on Taxation, states in footnote 14 at page 446 that the ISO tax preference is intended to apply to stocks sold in a disqualifying disposition because the Reform Act provides for a basis adjustment for the amount of the preference. However, the basis adjustment provided for presently in Section 57(a)(3)(B) of the Code does not work smoothly when the time between an ISO exercise and a disqualifying disposition overlap the end of a tax year. Currently, with respect to Code Section 57, taxpayers have relied on all the underlying legislative history (prior to the General Explanation released on May 7, 1987) for the proposition that an early disposition of ISO stock, even in a taxable year subsequent to the year of exercise, would render the alternative minimum tax inapplicable to the exercise of the ISO. Because the basis adjustment provided in Code Section 57(a)(3)(B) only works completely when the ISO shares are held for the period required, the ISO tax preference should not apply to shares sold in a disqualifying disposition.

Furthermore a retrospective application of Act Section 107(c)(4) would be unfair to taxpayers who have relied on the present law in making decisions concerning ISOs. More specifically, relying on the legislative history of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), taxpayers have accepted ISOs from their employers, with the belief that they could avoid the imposition of the minimum tax by selling the ISO shares in a disqualifying disposition.

As evidenced by the legislative history of TEFRA, the proposed amendment to Section 57 contradicts the legislative intent behind establishing the ISO tax preference. When Congress enacted Section 57(a)(10),* it specifically noted that it did not intend "that the stock option preference apply . . . where the special tax treatment for incentive stock options does not apply because there is an early disposition as specified in Section 422A(a)(1), of the stock acquired through the exercise of the option." See H. R. Rep. No. 97-760 (Conf. Rep.), 97th Cong. 2d Sess. 475 (1982). 1982-2 C.B. 600, 603.

Furthermore, the Reform Act made no significant change in the treatment of an ISO tax preference under Section 57. The Reform Act merely redesignated Section 57(a)(10) as Section 57(a)(3) and added Section 57(a)(3)(B) which provides for an adjustment in basis when determining the amount of gain or loss on a subsequent sale of ISO shares. There was no indication in the Reform act or its legislative history which would have notified taxpayers that the ISO tax preference would apply to ISO shares sold in a disqualifying disposition.

Even the Internal Revenue Service did not perceive any significant change having been made to Code Section 57 by the Reform Act as evidenced by Private Letter Ruling (LTR 8713054) issued in December of 1986, after enactment of the Reform Act. In that ruling, the taxpayer had received ISOs from his employer to purchase shares of the corporation's stock. The taxpayer exercised the ISOs on June 16, 1986, and proposed to dispose of the ISO stock in a disqualifying disposition between January 1 and June 16, 1987. The Service ruled that the ISO preference would not apply to the proposed disposition of the stock, provided that the taxpayer actually made a disqualifying disposition of the stock. In reaching its decision, the Service noted: "[i]n enacting Section 57(a)(10), Congress did not intend for the incentive stock option preference to apply where there is (sic) early disposition of the stock acquired through the exercise of the option."

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*Note that Code Section 57(a)(10) was redesignated as Section 57(a)(3) by the Reform Act.

One additional observation should be made, namely the impact of the Code, if changed as proposed, upon state and local taxation. State legislatures have been hard-pressed to respond in a timely fashion to the massive legislation that the Reform Act indeed represented. Now, at this late date, to be first introduced to the new interpretation of Section 57 of the Code, an additional burden has been placed on state legislatures that likely cannot be met. In a state like New York, which has an add-on minimum tax but whose definitions of tax preference items flow from the Code, taxpayers can easily find themselves subjected to double taxation in the event of an early disposition where once they were not.

Both taxpayers and state governments need advance notice from the Federal government when laws that affect them and their citizenry are to be changed. However, as already noted, there was no indication in the Reform Act or its legislative history which would have notified either that the ISO tax preference would apply to ISO shares sold in a disqualifying disposition. In addition, because Section 107(c)(4) of the Act does not contain a separately-stated effective date, the changes made will be deemed to take effect as if they were included in Section 57 of the Reform Act. Act Section 119. Thus, the proposed change will be deemed effective for tax years beginning after December 31, 1986; for calendar year-taxpayers, that means January 1, 1987.

Needless to say, taxpayers were surprised and shocked when they first learned of Congress' "intent" to apply the ISO tax preference to stocks sold in a disqualifying disposition upon the release on May 7, 1987 of the General Explanation of the Tax Reform Act of 1986. The change proposed by Act Section 107(c)(4) is a substantial and substantive change in the Code's application of the alternative minimum tax to ISOs which punishes those taxpayers who must transfer their shares before the expiration of their requisite holding period. Moreover, to compound the unfairness, it is proposed that the change be retroactively applied. Accordingly, we propose that Section 107(c)(4) be removed from the Act, that the Congress separately consider the substantive change sought to be made therein, and that if the provision is eventually adopted into law, it have prospective effect only.

Very truly yours,

Kirkpatrick & Lockhart

Kirkpatrick & Lockhart

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July 24, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finançe
SD-205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

We appreciate the opportunity to comment on Section 107 of S.1350, the Technical Corrections Act of 1987, on behalf of several municipal bond insurance companies.

The attached memorandum discusses the reasons why we believe Sections 55(c)(1) and 56(c) of the Internal Revenue Code (the "Code") should be amended in order to conform the alternative minimum tax to the Section 832(e) rules allowing municipal bond insurance companies to pay tax through purchases of non-interest bearing "tax and loss bonds." Our proposed corrections both treat the purchase of tax and loss bonds by a municipal bond insurance company as a payment of regular tax for purposes of determining the amount of the alternative minimum tax, and exclude the deduction under Code Section 832(e) for purposes of computing alternative minimum taxable income. Our proposed corrections also provide for appropriate adjustments upon the restoration of reserve amounts to income under Code Section 832(e)(5).

As discussed in the accompanying memorandum, the alternative minimum tax will, in the case of municipal bond insurance companies, result in the imposition of additional tax on income which is subject to the economic equivalent of a current, regular tax. This problem arises because the alternative minimum tax does not operate in conformity with the rules under Code Section 832(e) which were designed to provide for current payment of tax by municipal bond insurers without a corresponding reduction to permitted assets for statutory accounting purposes. Thus, elimination of this "double tax" result from the alternative minimum tax should not conflict with the Congressional intent of assuring that "no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits." (S. Rep. No. 313, 99th Cong. 2d Sess. 518-519 [1986].)

We would appreciate the opportunity to testify before the Committee on this matter.

Sincerely,

Ethel Z. Geisinger

Robert L. Cohen

July 20. 1987

MEMORANDUM

REGARDING

NECESSITY FOR TECHNICAL CORRECTIONS TO THE TREATMENT OF PURCHASES OF TAX AND LOSS BONDS BY MUNICIPAL BOND INSURERS UNDER THE ALTERNATIVE MINIMUM TAX

I. Summary of Issue

This memorandum discusses the rationale for technical corrections to Sections 55(c)(1) and 56(c) of the Internal Revenue Code of 1986, as amended (the "Code"). The proposed corrections would treat the purchase of "tax and loss bonds" by a municipal bond insurance company as a payment of regular tax for purposes of determining the amount of the alternative minimum tax and would exclude the deduction under Code Section 832(e) for amounts set aside by an insurer in a contingency loss reserve for purposes of computing alternative minimum taxable income.

As explained below, the alternative minimum tax imposed under Code Section 55 has the effect, in the case of municipal bond insurance companies, of taxing the same income twice, to the extent that amounts required under state insurance laws to be set aside in a contingency loss reserve increase the tax preference measured by the excess of adjusted net book income over alternative minimum taxable income before inclusion of this preference.

This double-taxation result occurs because the alternative minimum tax does not operate in conformity with the special rules governing the taxation of contingency loss reserve additions under Code Section 832(e). Under this provision, amounts set aside in a contingency loss reserve are subject to the economic equivalent of a current tax through the requirement that a company purchase non-interest bearing tax and loss bonds from the Treasury in the amount of the tax benefit attributable to treatment of the reserve additions as a deduction. The suggested corrections are necessary in order to maintain the economic and tax policy objectives underlying the enactment of Section 832(e).

II. Operation of Section 832(e)

A municipal bond insurance policy is an unconditional and irrevocable guarantee of payments of principal and interest on a municipal bond when due. The premium for the policy is generally paid in full at the closing of the bond issuance.

To protect policyholders against extraordinary losses which could be incurred by an insurer either during an adverse economic period or as a result of declining insurance revenues, state insurance laws require municipal bond insurance companies to maintain a contingency loss reserve, funded by a certain percentage of the insurer's earned premiums on an annual basis. The amounts required to be set aside in the contingency loss reserve are not related to the actual loss experience of the insurer, and current losses and expenses of the insurer are not charged to the reserve.

Typically, state laws require that such amounts must remain in the contingency loss reserve for a specified number of years in the absence of authorization from the state insurance commission for prior restoration to income. New York law, for example, requires that municipal bond insurers annually set aside 50% of earned premiums and retain such amount in the contingency loss reserve for 20 years. See 11 N.Y.C.R.R. §63.2(a)(2).

The state law reserve requirement raises a difficult conflict between federal tax policy and the business concerns of municipal bond insurers. The substantial reserve funding requirement results in a depletion of an insurer's working capital because amounts required to be set aside in the contingency loss reserve may not generally be used to pay current losses or expenses. Generally, the ability of a municipal insurer to write additional insurance is subject to state law limitations based on the sum of the insurer's capital, surplus and contingency loss reserve. The imposition of a current tax on premiums required to be set aside in the contingency loss reserve would exacerbate the drain on an insurer's assets, thereby further restricting its business and, in certain cases, increasing a competitive disadvantage resulting from a particularly high state law funding requirement. However, because amounts required to be set aside in the contingency loss reserve are not based on actual loss experience, deferring tax on such amounts until their restoration to income several years later would provide a substantial tax benefit to the insurer not available to other taxpayers.

Code Section 832(e) (originally applicable only to mortgage guaranty insurers which are subject to similar contingency loss reserve requirements and later amended to apply to municipal bond insurers as well) was specifically enacted to fashion a compromise between such competing concerns. See S. Rep. No. 918, 90th Cong., 1st Sess. (1967); H. Rep. No. 93-1405, 93rd Cong. 2nd Sess. (1974) 4-5; and Remarks of Sen. Bennett, 120 Cong. Rec. S14854 (August 13, 1974). Under this provision, a municipal bond insurer is permitted a deduction from gross income for the amount of earned premiums required under state law to be set aside in a contingency loss reserve, but only to the extent that the insurer purchases certain tax and loss bonds from the Treasury in the amount of the tax benefit attributable to the deduction. The "tax and loss bonds" do not bear interest and are non-transferable. Code Section 832(e)(2) requires that the bonds be purchased on or before the date that any taxes (determined without regard to Section 832(e)) for the taxable year for which the deduction is allowed are due to be paid. The tax and loss bonds are redeemable only when, under Code Section 832(e)(5), the amount added to the contingency loss reserve must be restored to income. At such time, the redemption proceeds are typically used to pay the tax liability resulting from the restoration of the reserve to income.

From the insurer's standpoint, the deduction for additions to the contingency loss reserve does not give rise to an immediate tax benefit, since such "benefit" must be invested in non-interest bearing bonds. A non-tax benefit results from the payment mechanism, however, because the tax and loss bonds are recognized as assets by both state insurance commissions and accountants for statutory accounting purposes. Thus, the current "tax" imposed on the reserve amount has no effect on a company's ability to write additional insurance or pay current losses and expenses.

Similarly, from the Treasury's standpoint, the tax and loss bond mechanism does not result in a revenue loss, since the non-interest bearing bonds provide the Treasury with the unrestricted use of the insurer's "tax deferral" as if there were no deduction and as if taxes were in fact paid currently. Although the insurer obtains a deduction for the addition to the contingency loss reserve, the insurer is denied the earnings on the portion of its reserve representing deferred taxes during the period such portion is held in the reserve. This result is consistent with the treatment by accountants under generally accepted accounting principles ("GAAP") which recognize the purchase of tax and loss bonds as a payment of tax on an insurer's financial statement.

III. Effect of the Alternative Minimum Tax

The accommodation of competing business and tax policy concerns under Code Section 832(e) is disrupted by the new alternative minimum tax under Code Section 55 which imposes a second tax on the additions to the contingency loss reserve. Under Code Section 55(a), the amount of minimum tax due is the excess of tentative minimum tax over regular tax. In its present form, the alternative minimum tax does not treat the purchase of tax and loss bonds as a payment of current regular tax. Code Section 56(f) treats as a preference item 50% of the excess of adjusted net book income over alternative minimum taxable income . The computation of the latter amount would include the deduction provided under Code Section 832(e) for a contingency reserve addition. However, the additions to the reserve are not recognized as a deduction for GAAP purposes. As a result, book income (as reported on an insurer's GAAP financial statement) will exceed alternative minimum taxable income in the amount of the reserve addition.

The application of the alternative minimum tax to a municipal bond insurer may be illustrated by the following example. Assume that for the 1988 taxable year a municipal bond insurance company has $10 million of taxable income after receiving a $25 million deduction under Code Section 832(e) for amounts placed in a contingency loss reserve. In addition to paying regular tax of $3,400,000 ($10 million x 34%), the company is required as a condition of obtaining the benefit of the Section 832(e) deduction to purchase tax and loss bonds in the amount of the tax benefit attributable to the deduction ($25 million x 34% = $8,500,000). Thus, the company pays, in effect, the equivalent of a current tax on $35 million.

With respect to the company's minimum tax position, if the only adjustment or preference applicable to the company's taxable income is the Code Section 56(f) book income adjustment, the company's adjusted net book income is $35 million (since the deduction for amounts placed in contingency loss reserves is not allowed in determining book income under GAAP). The book income preference will increase alternative minimum taxable income by 50% of the excess of $35 million over $10 million (alternative minimum taxable income before the addition of this item of preference), or $12,500,000. Thus, alternative minimum taxable income will equal $22,500,000 ($12,500,000 plus $10,000,000), and the resulting tentative minimum tax under Code Section 55(b) will be $4,500,000 ($22,500,000 x 20%). The alternative minimum tax, therefore, will be $1,100,000 (the excess of the $4,500,000 tentative minimum tax over the $3,400,000 regular tax). This $1,100,000 represents a direct tax on the $25 million added to the contingency loss reserve in addition to the effective tax paid (at the higher regular tax rate of 34%) in the form of the purchase price paid for tax and loss bonds.

IV. Policy Reasons for Corrections
To The Alternative Minimum Tax

Applying the alternative minimum tax to additions to contingency loss reserves ignores the special rules for taxing such amounts already in effect under Code Section 832(e). By requiring the purchase of tax and loss bonds in the amount of the tax savings attributable to deductions for additions to contingency loss reserves, Congress ensured that the flow of funds to Treasury would not be adversely affected, as Treasury receives the equivalent of a current tax on amounts added to the reserve in the form of payments for the tax and loss bonds.

Consideration of Congress' "overriding objectives" in enacting the alternative minimum tax makes it even more apparent that the alternative minimum tax should not apply in this case. The legislative history makes clear that the principal purpose of the tax is to ensure that "no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits." S. Rep. No. 313, 99th Cong., 2nd Sess. 518-520 (1986). None of the intended objectives of the alternative minimum tax are served by taxing additions to contingency loss reserves. As has been shown, municipal bond insurance companies do not avoid tax liability, since the "tax savings" associated with the Section 832(e) deduction must be paid to Treasury in exchange for non-interest bearing bonds. Thus, not only is there no permanent tax avoidance, there is not even a deferral of payments to Treasury. Treasury receives the same payment, and at the same time, as if the deduction were not allowed.

V. Suggested Technical Corrections

To alleviate the double tax problem discussed above, it is suggested that the amount paid for tax and loss bonds with respect to the deduction allowed under Code Section 832(e) be treated as a payment of regular tax for purposes of the alternative minimum tax and that the deduction permitted under Section 832(e) be denied for purposes of computing alternative minimum taxable income. These corrections, with appropriate adjustments for years in which amounts in a reserve are added back to income under Code Section 832(e)(5), could be accomplished in the following manner:

(i) Amend Section 55(c)(1) by re-designating paragraph (2) as paragraph (3) and adding a new paragraph (2) to read as follows:

> "(2) For purposes of this section, "regular tax" shall be increased by the total amount paid for tax and loss bonds under Section 832(e) with respect to the deduction permitted under Section 832(e)(1) for the taxable year and shall be decreased by the amounts received in redemption of such bonds pursuant to an addition to gross income under Section 832(e)(5)."

(ii) Amend Section 56(c) by adding a new paragraph (4) to read as follows:

> "(4) Special Rule for Mortgage Guaranty and Municipal Bond Insurance Companies.-- The deduction determined under Sections 832(c)(13) and (e)(1) shall not be allowed and any addition to gross income under Section 832(e)(5) shall be disregarded."

VI. Summary

The sole effect of Section 832(e) is to construct a fiction for the purpose of alleviating the disastrous consequences of regulatory accounting for state law reserve requirements. Although the provision gives the appearance of reducing taxable income and tax paid, in reality the insurer's obligation for income tax is economically settled in the identical manner that it would have been if Section 832(e) did not exist. Presently, however, the alternative minimum tax operates to treat the "fictional preference" of Section 832(e) as though it were a "real preference." The corrections proposed in this memorandum would restore the insurer to exactly the same alternative minimum tax position it would be in without Section 832(e).

Kutak Rock & Campbell

Lawrence University
Development Office

July 22, 1987

Ms. Laura Wilcox
Senate Committee on Finance
205 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Ms. Wilcox,

Senate Bill 1350, currently under consideration by the Finance Committee, proposes a number of adjustments to the Internal Revenue code of 1986. In response to the Committee's request for comments, I would like to ask that the committee correct one important omission -- specifically, that it seek a provision clarifying that Section 501(m) of the Code does not pertain to issuers of charitable gift annuities.

Section 501(m) was created by the Tax Reform Act of 1986 and provides that tax-exempt organizations deriving a substantial portion of their revenue from "commercial-type" insurance may be subject to the unrelated business income tax on that revenue. Annuities are properly considered to be commercial-type insurance for purposes of that section, but the new law seems ignorant of the distinction between charitable gift annuities and commercial annuities, and it has been reported that some congressional staff believe that section 501(m) should apply to gift annuities.

In fact, however, gift annuities -- like pooled income funds, charitable remainder annuity trusts and unitrusts, and gifts of real property with retained life estate -- do not represent a private investment option but are, rather, a means of making an irrevocable charitable gift while retaining an income from the gift property. Gift annuities are, in fact, the oldest form of life income gift, having been issued since the early part of this century, and they have never been treated as an unrelated trade or business. (IRC section 514(c)(5), added by the Tax Reform Act of 1969 and unchanged in the 1986 law, makes this clear.)

An irrevocable donation to a charity, accompanied by a promise from the charity to pay a stated annual income for life, is completely different in character from the lump-sum or installment purchase of an income stream from a commercial insurer. Only private purposes are served by the latter, but the former always results in a substantial and permanent transfer of value to the issuing institution, thus advancing the public weal by supporting the mission of a non-profit educational, cultural, scientific, medical, or charitable institution.

Appleton, Wisconsin 54912 414-735-6517

In the case of a commercial annuity, the purchaser simply converts financial assets from one form to another and the issuing company gains the opportunity for a profit on the transaction. But in a gift annuity, the donor voluntarily contributes finanical assets to a charity, and the income stream received in return is always a fraction of the value of the contributed property. The commercial annuity is an investment, intended to safeguard or enhance the financial condition of the purchaser. But the gift annuity is a charitable contribution; the donor gives up property in order that the purposes of a charity may be advanced.

Far from representing an unrelated trade or business, then, gift annuities are simply and strictly another form in which those interested in our nation's charities exercise their financial support of those institutions and their exempt missions. It is difficult to understand the logic that would identify these contributions with a commercial purpose.

Since confusion has arisen, however, as to whether Code section 501(m) applies to gift annuities, clarification is needed. Accordingly, because the Internal Revenue Code, in section 514(c)(5), already contains provisions governing the application of UBTI to gift annuities, and because careful analysis discloses that charitable gift annuities are absolutely different in purpose and in result from commercial annuity products, I would urge that the technical corrections bill clarify that Code section 501(m) does not apply to charitable gift annuities.

Thank you for your consideration.

Sincerely,

Stephen A. Hirby

Stephen A. Hirby
Director of Development
414/735-6553

SAH/kan

LEBOEUF, LAMB, LEIBY & MACRAE
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS
520 MADISON AVENUE, NEW YORK, N. Y. 10022

MEMORANDUM: DATE July 23, 1987

FOR: Mr. William J. Wilkins, Staff Director and Chief Counsel, Senate Committee on Finance

FROM: LeBoeuf, Lamb, Leiby & MacRae

SUBJECT: Problems Arising in the Application of Certain Provisions of the 1986 Tax Act to Group Captive Insurance Companies

The interaction of several provisions of the 1986 Tax Reform Act create serious problems for "group captive" insurance companies. If the branch level tax ("BLT") is applied to corporations which are subject to the tax regime imposed by new section 953(c) the Internal Revenue Code of 1986 (the "Code") such corporations would become subject to at least three levels of taxation. This results in a significantly higher tax liability than that imposed on either similar domestic corporations or similar foreign corporations that are not engaged in a United States trade or business.

In Notice 87-50, the Internal Revenue Service ("IRS") took the view that the BLT imposed by new section 884 applies to those group captive insurers which are engaged in a U.S. trade or business and which make the section 953(c)(3)(C) election. That is, IRS takes the view that the exception from the BLT provided in section 884(d)(2)(D) does not apply to "effectively connected income."

If this view prevails, the combined impact of the BLT and section 953(c) will be devastating. An electing foreign insurer which follows traditional practice by investing its premiums in Eurodollar securities will virtually always have a substantial BLT liability.[1]

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1 The mechanics of the BLT apparently were drafted on the assumption that unless the "branch" makes a distribution to the "home office" its increased (continued...)

As discussed in more detail below, it is particularly inappropriate to impose the BLT on such group captive insurers, and legislation will be necessary to cure the problems created by the application of the BLT in these circumstances.

SUMMARY

1. The BLT is currently being applied to "group captive insurers" which are engaged in a U.S. trade or business and which make the section 953(c)(3)(C) election. Such corporations thus are placed in a worse position than similarly situated domestic insurers or similarly situated foreign insurers not engaged in a U.S. trade or business.

This problem, as well as the other problems raised herein, could be solved by legislation modifying the section 953(c)(3)(C) election to provide that an electing corporation will be treated as if it were a domestic corporation (the "Domestic Election"). Alternatively, it could be solved by legislation providing that the BLT does not apply to "effectively connected income" which also qualifies as "related person insurance income" earned by corporations which make the section 953(c)(3)(C) election (the "Ordering Rule").

2. If the BLT is permitted to apply to group captive insurers, difficult technical questions arise. These include how the reduced deductions for unearned premium reserves and for loss reserves should be taken into account in calculating "U.S. net equity", and whether earnings and profits attributed to income generated by loss reserve discounting which is exempt from tax pursuant to the "fresh start" should be subject to the BLT. Legislation will be required to smooth these anomalies.

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[1](...continued) earnings and profits will generate increased "U.S. net equity" which will defer the tax. This is not the case for most property/casualty insurance companies which invest their reserves and capital in Eurodollars.

ANALYSIS AND PROPOSED SOLUTIONS

A. BLT Issues.

1. The BLT Should Not Apply. It is not clear that, as a matter of sound tax policy the BLT should be applied to a foreign corporation to the extent it is owned by U.S. persons.[2] This question becomes even more debatable in the circumstances under consideration in view of the premise underlying the enactment of new section 953(c), *i.e.*, that group captive insurers should be taxed as if they were domestic corporations.

If the BLT is applied to a group captive insurer that is actually engaged in a U.S. trade or business, the income of the group captive is subject to at least three levels of tax, *i.e.*, the corporate tax, the BLT, and tax at the shareholder level (often without a dividends received deduction under new section 245).[3] There is a fourth level of tax if the Federal insurance premiums excise tax is

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2 The purpose of the BLT is to treat U.S. branches of foreign corporations as if they were U.S. subsidiaries and to impose a tax equivalent to the withholding tax on dividends. Implicit in this theory is the assumption that if income can be shifted from the "branch" to the "home office" it will not again be subject to U.S. income tax. Such an assumption is obviously incorrect in the case of a foreign corporation owned by U.S. shareholders. This point was recognized in the House Bill which provided a credit to U.S. shareholders for their share of the BLT upon a distribution by the foreign corporation.

3 Section 245 was amended by the 1986 Act to provide a dividends received deduction with respect to dividends paid by a foreign corporation from "effectively connected income" only to 10 percent shareholders.

deemed to apply.[4] In contrast, the income of a domestic corporation owned by the same shareholders would be subject to two layers of tax, i.e., one tax at the corporate level and one at the shareholder level (with the dividends received deduction always available). A similar foreign corporation which was not engaged in a U.S. trade or business would be subject only to one tax at the shareholder level if it did not make the section 953(c)(3)(C) election.[5] Such a disparity in treatment is inconsistent with both the policy implemented through the election and with sound tax policy in general.

In significant instances, U.S. corporations needing insurance have formed foreign insurers because domestic insurance laws would not permit the formation and operation of a domestic carrier in the manner required by business necessities. To adequately serve their insureds, some of these insurers have formed U.S. offices, entered contracts with U.S. agents, or otherwise conducted their activities in ways requiring substantial U.S. contacts.

The statute should not apply in a way that imposes tax penalties on corporations which are required by non-tax regulatory constraints to be domiciled in offshore jurisdictions, and which, in order to serve their domestic policyholders, either consciously (or inadvertently) become engaged in a U.S. trade or business. These carriers should not be taxed more heavily than both their foreign and domestic counterparts.

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4 The reasoning that causes the exemption from the BLT contained in section 884(d)(2)(D) to be inapplicable to "effectively connected" RPII would also seem to render inapplicable the excise tax exemption contained in section 953(c)(3)(D)(ii).

5 Subsequent "dividend" distributions would not attract tax at the shareholder level by virtue of section 959.

2. Proposed Legislative Solutions. A legislative solution[6] specifically tailored to group captive insurers is to modify section 953(c)(3)(C) to provide the Domestic Election. In effect, the electing corporation would agree to become subject to U.S. tax on its worldwide income in exchange for relief from the BLT problem. It is notable that the dividends received deduction problem, and the Federal excise tax problem briefly referred to herein would also be eliminated.

A second legislative solution, which would have a more limited effect, is to provide the Ordering Rule.[7] Obviously, "effectively connected RPII" cannot be taxed twice and an ordering rule is required to determine whether the income should be taxed under section 882 and excluded from taxation by virtue of the section 953(c)(3)(C) election, or conversely. Thus, legislation providing an ordering rule treating RPII as within the scope of the section 953(c)(3)(C) election would be appropriate. It would not *per se* exempt group captive insurers from the BLT. The tax would still apply to the extent that, for example, the foreign corporation provided insurance to non-

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6 Presumably, the position expressed in Notice 87-50 is based on section 952(b) which provides that effectively connected income may not be characterized as Subpart F income. This position is not required by the statute. Section 953(c)(1) provides that "[f]or purposes of taking into account "related person insurance income" the 10 percent test for a United States shareholder and the 50 percent test for a "controlled foreign corporation" ("CFC") are modified. Section 953(c)(2) defines "related person insurance income" (without reference to section 952(b)), and section 953(c)(3)(C) provides that if the election is made, the corporation will not be a CFC by virtue of the section 953(c)(1) rule. Section 952(b) does not exclude "effectively connected income" from characterization as RPII.

7 This solution would also solve the excise tax problem referred to above.

shareholders or to foreign shareholders, as income attributable to that insurance would not constitute RPII.

B. Technical Problems in the Application of the BLT.

1. Insurance Accounting Issues. If the BLT is to be applied to corporations subject to section 953(c), several problems raised by the 1986 changes to the insurance accounting rules must be addressed. These problems, in particular the "fresh start" issue discussed below, will require special legislative solutions unless the BLT problems discussed in section A above are cured.

First, sections 832(b)(5) and 846 require loss reserves to be discounted for purposes of calculating underwriting profits. This raises two questions. The first is whether reserves established for "claims made but not paid" or for "incurred but not reported losses" should be treated as "liabilities" for purposes of the U.S. net equity calculation.[8] If so, then a determination must be made as to whether the amount of such liabilities is their full value or their discounted value pursuant to section 846.

It is clearly inappropriate to treat the full value of a loss reserve as a liability for BLT purposes. The statute provides that only the discounted value can be taken as a deduction. It would also be unsound policy to take the position that the "discount" creates underwriting profits which, in turn, create a contingent BLT and that 200 percent of this amount[9] must be covered with U.S. assets to defer the liability.

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8 The question whether loss reserves and unearned premium reserves should be treated as "liabilities" for tax purposes has implications beyond section 884. It is closely related to the question whether section 832 or section 108 applies to the write-off of reserves of an insolvent insurance company. Several years ago, IRS was asked to rule on these issues, but, to date, has not done so.

9 The discount would have to be covered once because the undiscounted value of the reserve was treated as a liability, and a second time to generate a sufficient increase in U.S. net equity to cover the underwriting profits.

A second accounting problem that arises in connection with the new provisions requiring that loss reserves be discounted results from the transitional rule. Generally, the 1987 opening balance is the discounted value of the 1986 ending balance.[10] Income generated by this reduction in reserves is not required to be taken into income, i.e., the "discount" is exempt from tax pursuant to a "fresh start" rule. However, the statute specifically provides that this fresh start discount generates earnings and profits. Act, section 1023(e)(2) and (3). Thus, unless some relief is provided such earnings and profits would be subject to the BLT even though the "income" they represent would not be subject to income tax.

Legislation to mitigate this effect would clearly be appropriate unless legislation eliminating the effect of the BLT on group captive insurers were enacted. Such legislation would be very similar in concept to the amendment proposed in section 112(h)(6) of the Technical Corrections Bill of 1987.

It is not clear that the amendments to section 884(b)(2) contained in section 112(o) of the Technical Corrections Act address these problems. Those amendments exclude pre-1987 earnings and profits from the BLT. The discounting rules and the rules discussed below regarding amortization of the unearned premium reserve would create 1987 earnings and profits with respect to reserve items established in 1986 by requiring, in effect, that a portion of 1986 reserves be taken into income in 1987. Both "fresh start" earnings and profits and those resulting from income generated because of 1986 reserve strengthening are actually generated with respect to transactions that took place prior to the 1987 tax year (i.e., the effective date of the BLT) and thus should not be treated as subject to the BLT.

A third accounting problem is the treatment of the unearned premium reserve. For tax years beginning after December 31, 1986, a deduction is allowed for only 80 percent of increases to the unearned premium reserves. Further, 20 percent of the closing balance of that reserve for the 1986 tax year is taken into account ratably over six years. The tax accounting for this reserve raises the same questions as those raised with respect to the loss reserve discounting rules and requires a similar solution.

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10 This reserve reduction is not permitted for "reserve strengthening" that took place in 1986.

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June 30, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D. C. 20510

Re: Technical Corrections Act of 1987 (the "Act")

Dear Ms. Wilcox:

Section 111A(e)(3) of the Act amends section 1131(d) of the Tax Reform Act of 1986 by adding the following special effective date for certain collectively bargained pension plans:

> In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1987, the amendments made by this section shall not apply to contributions pursuant to any such agreement for taxable years beginning before the earlier of -
>
> (A) January 1, 1989, or
>
> (B) the date on which the last of such collective bargaining agreements terminates (determined without regard to an extension thereof after February 28, 1986). ("Emphasis added.")

If the special rules for collective bargaining agreements are intended to apply in those cases where the agreement was ratified before March 1, 1987, it is unclear why subparagraph (B) refers to extensions after February 28, 1986." The Joint Committee on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) (JCS 15-18), June 15, 1987, at pages 140 and 141 suggests that this rule was intended to apply only where the agreement was ratified before March 1, 1986.

Thank you for your attention to this.

Sincerely,

Stephen Pavlick

Stephen Pavlick

Comments Regarding Technical Corrections Needed to Resolve Inequalities of Tax Treatment of Foreign and U.S. Scholarship Recipients Resulting From Section 123 of the Tax Reform Act of 1986

Submitted to the Committee on Finance of the United States Senate

July 22, 1987

By the Liaison Group for International Educational Exchange
1825 I St., NW, Suite 475, Washington, DC 20006

On behalf of the following organizations:

Academy for Educational Development
African-American Institute
America-Mideast Educational and Training Service
American Association of Collegiate Registrars and Admissions Officers
American Association of Community and Junior Colleges
American Association of State Colleges and Universities
American Council on Education
Association of American Universities
Association of Catholic Colleges and Universities
Association of International Education Administrators
Association of Jesuit Colleges and Universities
College Board Office of International Education
Commonwealth Fund (The Harkness Fellowships)
Community Colleges for International Development
Council of Graduate Schools in the United States
Council of International Programs
Council on International Educational Exchange
Council on International Exchange of Scholars / American Council of Learned Societies
Educational Testing Service
Fulbright Alumni Association
Institute of International Education
International Research and Exchanges Board / American Council of Learned Societies
Latin American Scholarship Program of American Universities
National Association for Foreign Student Affairs
National Association of Independent Colleges and Universities
National Council for International Visitors

The Liaison Group for International Educational Exchange, a coalition representing major nonprofit organizations engaged in international educational exchange programs, is pleased to respond to the Committee's request for comments on proposed technical corrections to the Tax Reform Act of 1986. We submit these comments on behalf of the organizations listed above, including major higher education associations and organizations having principal administrative responsibilities for the Fulbright Program, the Hubert Humphrey North-South Fellowship Program, the Agency for International Development's Participant Training Program, and other major federal international scholarship programs.

We are deeply concerned about the unintended impact on these programs of changes made regarding taxation of scholarships and fellowships by Section 123 of the Tax Reform Act. Our comments are confined to technical corrections needed to resolve problems resulting from this section of the Act.

Before going into the substance of our recommendations, we want to express our gratitude to the Committee for its sympathetic approach to these concerns. Inclusion in S. 1350 of Section 101(d)(2), which would extend the 14% withholding rate to certain foreign students and scholars holding F, J, and M visas now subject to withholding at the rate of 30%, is a very important and useful step toward resolving one of our major concerns.

However, the far-reaching changes in scholarship and fellowship taxation made through Section 123 resulted in several severe though, we believe, unintended problems. More comprehensive remedies are, therefore, urgently needed within the technical correction legislation to deal with other dimensions of these problems.

In essence, Congress' decision to limit the extent to which scholarships and fellowships may be excluded from gross income has had the effect of exposing foreign students and scholars to extremely unfavorable provisions of tax law. As a result, there now exists a great disparity in tax treatment between foreign and American recipients of scholarships and fellowships for participation in international educational exchange programs.

The legislative history of Section 123 indicates that the provision's principal motivation was to equalize taxation of funds used for educational expenses. For this reason, it is our hope that the Committee will seek to further this policy objective by taking several steps to improve Section 101(d)(2) to remedy the inequality of tax treatment between those who receive scholarships and fellowships who are U.S. citizens and those who are nationals of other nations.

As you can well imagine, this problem has considerable urgency for our community since reciprocity is an essential ingredient to international educational exchanges. The growing perception abroad that foreign recipients of scholarships and fellowships are unfairly treated under U.S. tax law is extremely damaging to the conduct of our programs. The Government of Spain, to cite just one example, is considering ending its substantial support for the Fulbright Program due to these changes in tax law. Similarly, many foreign governments and other foreign scholarship sources are beginning to send their sponsored students to other nations which do not tax their awards and welcome the considerable income brought to their educational institutions and economies through the education of foreign students.

Here, in summary, are the problems needing resolution as a result of the scholarship and fellowship changes made through Section 123 of the Act:

<u>Excessive taxation rates of foreign recipients of scholarships and fellowships</u>

The Problem: It was the intention of Section 123 of the Tax Reform Act to expose scholarship and fellowship income to increased taxation. In doing this, we believe it inadvertently exposed foreign grant recipients to much higher effective rates of taxation. These higher rates are due to filing requirements which apply to 'F' and 'J' category nonimmigrants. Since such individuals must file taxes as nonresident aliens for a specifed number of years, these scholarship and fellowship recipients cannot reduce their taxable income by means of the standard deduction or by the use of more than one personal exemption (if they would otherwise be entitled to them). For this reason, many U.S. student recipients of awards will either fall below the threshold of taxable income or be only subject to modest taxation levels, while foreign recipients will in most cases be taxed on all amounts above $1950 and the taxation level for these recipients is very high.

Consider the hypothetical case of two recipients of a scholarship to participate in an international exchange program. One is a U.S. citizen who is married and has one child. The other is a foreign citizen, also married with one child. They each receive an award of $17,000, only $7,000 of which is used for qualified tuition or related expenses (leaving $10,000 of taxable income).

	The U.S. Student Recipient	The Foreign Student Recipient
Taxable Income	$10,000	$10,000
Withholding from Income	$0	$10,000 - 1,950 (personal exemption) $8,050 x .14 $1,127
Tax Liability	$10,000 - 5,850 (personal exemptions) - 5,000 (standard deduction) $0	$10,000 - 1,950 (personal exemption) $8,050 x .15 $1,208

The impact on exchange programs is equally dramatic. USIA estimates that the administrative costs of withholding funds from Fulbright and other awards and reporting requirements due solely to the new tax requirements on foreign recipients will cost between one half and one million dollars per year. The agency also estimates that more than 10 percent of its scholarship dollars are lost due to nex tax requirements.

The loss to important privately funded programs is also damaging to international educational exchanges. For example, the Commonwealth Fund estimates that the new federal tax liabilities on its Harkness Fellowships resulting from the Section 123 changes will total $32,000. This is equivalent to five percent of its awards under the program -- or one full scholarship which it will not be able to award to a bright young Australian, British, and New Zealand student for study in the United States.

Suggested Solution: Allow foreign scholarship and fellowship recipients the option of filing as a resident alien for tax purposes. By allowing these individuals to be entitled to the standard deduction and (if eligible) to more than one personal exemption, the great inequality of taxation between foreign and U.S. recipients of scholarships and fellowships would be eliminated. Although the Tax Reform Act did not substantially modify the filing requirements of 'F' and 'J' nonimmigrants, the proposed change is warranted in the technical corrections legislation because it alleviates an unintended inequality of tax treatment resulting from passage of Section 123 of the Tax Reform Act.

This proposal could be implemented through an amendment to Section 7701(b)(5)(E) of the tax code to allow foreign teachers, trainees, and students to elect to be treated as "exempt individuals" and thus to satisfy the provisions of the substantial presence test for purposes of being treated as a U.S. resident for tax purposes. An individual making the election would be eligible to do so even for his first taxable year in the United States under the new "first-year election" provision of 7701(b)(4). The election could be made available only on a permanent basis, revokable only with the consent of the Commissioner.

Subjecting foreign recipients and organizations providing their grants to excessive withholding and reporting requirements

The Problem: While U.S. recipients of scholarships and fellowships are not subject to withholding on their awards (even though portions of their awards are subject to taxation), foreign recipients are subject to withholding at either a 14% or a 30% rate (depending on whether or not portion of their award qualifies for exclusion under Section 123). As a result, there is a great disparity of treatment between foreign and U.S. recipients of scholarships and fellowships. U.S. recipients benefit by having access to their full awards even if they may owe taxes on it, while foreign recipients' awards are reduced through the withholding process even if they ultimately owe little or no taxes upon them. This is a great hardship since foreign students receiving these awards usually have no other source of financial support and their stipends are based on standardized cost-of-living indices set to meet basic minimum expenses. In the case of those young scholars without other income who cannot meet the new statute's test of a qualified scholarship or fellowship, the required withholding rate of 30% is a staggering burden.

In addition, the organizations which provide scholarships and fellowships to foreign individuals are unfairly subjected to withholding and reporting procedures which do not apply to organizations only giving awards to U.S. recipients. There is no compelling reason for this inequality of treatment.

Since the thrust of Section 123 appears to aim at equalizing tax treatment of funds used for educational expenses, we believe this inequality should be reduced and hopefully eliminated.

Suggested solutions: Several options appear to be worthy of consideration, (one of which has been incorporated into the Technical Corrections bill as introduced).

— Amounts received by nonresident aliens temporarily present in the United States as nonimmigrant 'F','J', or 'M' visa holders which are incident to a qualified scholarship, or amounts received by such individuals from educational organizations, foreign governments, international organizations, Fulbright Commissions, etc. (as defined in section 101(d)(2) of H.R. 2636) could be specifically exempted from withholding requirements. This is, we believe, the fairest and best solution, since it provides true equality between foreign and U.S. recipients of scholarships.

— The existing exclusion of amounts received for maintenance by recipients of scholarships or fellowships under the authority of the Foreign Assistance Act through Section 1441(c)(6) of the Tax Code could be extended to recipients of awards provided by organizations defined under Section 101(d)(2) of H.R. 2636. Alternatively, this extension could be limited to those receiving awards under the authority of the Mutual Educational and Cultural Exchanges Act of 1961 as amended. If this approach is adopted, we urge that amounts paid for travel should also be excluded from funds subject to withholding, since travel to and from the educational institution in the United States is, like room and board, an essential incidental expense to the educational program itself for the foreign student.

— Those whose awards do not qualify under the Section 123 definition of a qualified scholarship or fellowship could be made eligible for the lower 14% withholding rate. A provision to accomplish this has been included in H.R. 2636. The Liaison Group appreciates the inclusion of this provision, and urges the Committee to retain it in the legislation if the options defined above are not acceptable. A slight technical modification of the provision communicated to the Committee by Patton, Boggs, and Blow on behalf of the Council for International Exchange of Scholars should be approved if this approach is taken. This technical change would enable Fulbright Program lecturers and teachers to qualify for the 14% withholding rate.

Obviously, from our perspective, the first of these options is the most desirable approach. Any of these options, however, would be a useful step in resolving the withholding inequalities which have resulted from passage of Section 123.

Subjecting awards from foreign governments and organizations to U.S. taxation

The Problem: The Section 123 changes have exposed grants given by foreign governments or other foreign sponsors to highly unfavorable federal sourcing policies under which such awards are considered U.S. source income. Under this policy, the award is deemed taxable if the educational activity takes place in the United States, regardless of the actual source of the funds. Although this IRS sourcing rule has been in effect for many years, it has not been consequential to the conduct of exchange activities because the awards were normally excludable from taxable income as a scholarship or fellowship through the provisions of section 117. Now that awards are not fully excludable, sourcing policy is crucial.

Exposing these scholarship funds to U.S. taxation poses a serious threat to the Fulbright Program. Thirty nations besides the United States currently contribute funds to this crucial program now celebrating its fortieth anniversary. As noted above, Spain is now seriously considering ceasing its substantial contributions because its funds are taxed by the United States government. Other countries are similarly concerned, and significant loss of foreign support to the program can be expected if changes are not made.

Further, the policy is a strong disincentive for foreign scholarship sources to send students to the United States. The United States currently enjoys an enviable position in attracting many thousands of these students to our institutions each year. Foreign students not only help support our higher education institutions through their enrollments, but they also annually expend more than $2 billion in U.S. communities. Equally importantly, their presence on our campuses helps make them the international institutions they must be if they are to train our students for today's world. These benefits are seriously threatened by the effects of Section 123, as foreign sponsors choose to send their students to hosting nations which are happy to receive the income and do not attempt to tax it.

Suggested Solution: A provision is needed in the technical corrections legislation which specifically excludes from U.S. source income amounts received by nonimmigrant individuals with 'F', 'J' or 'M' visas for educational programs from foreign scholarship or fellowship programs.

The Liaison Group appreciates this opportunity to make these recommendations to the Committee regarding the proposed technical corrections bill and the needs of international exchange programs relating to this legislation. We are grateful to the staff of the Committee for the steps already taken in the legislation to relieve the serious inequalities between foreign and U.S. scholarship recipients which resulted from changes made in scholarship and fellowship taxation by Section 123 of the Tax Reform Act. I hope these additional suggestions are useful to the Committee in resolving these problems. Naturally, we are prepared to offer whatever additional assistance we can to the Committee toward this objective.

Loma Linda University

Department of Planned Giving
Loma Linda, California 92350
714/824-4553

July 7, 1987

Senate Finance Committee
U. S. Senate Committee on Finance, S.D. 205
Washington, DC 20510

Attention: Laura Wilcox

RE: Technical Corrections Act 1987 (H.R. 2636, S.1350)
- Charitable Lead Trusts

We understand that the above-captioned Bill would repeal the charitable deduction in computing the generation-skipping transfer tax (GSTT) on lead trusts created after June 10, 1987. It would do that by striking out IRC Sec. 2642(a)(2)(B)(ii)(II).

This seems to us to be a substantial change from last year's Act, discouraging an important source of support for charitable institutions. We therefore would urge you to allow the charitable deduction to remain in computing the (GSTT), Generation-skipping transfer tax.

Thank you for your attention to the above and your consideration of the benefits rendered by charitable entities to society and the support needed to sustain them.

Sincerely yours,

George Carambot
Director, Planned Giving

GC/ly

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July 10, 1987

Laura Wilcox, Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Re: Comment on Technical Corrections Bill

Dear Ms. Wilcox:

The purpose of this letter is to comment on one aspect of the proposed Technical Corrections Bill of 1987 (S. 1350, H.R. 2636) (the "Bill") pertaining to the generation-skipping transfer tax.

Chapter 13 of the Internal Revenue Code, as modified by the Tax Reform Act of 1986, imposes the generation-skipping transfer tax on certain "taxable terminations" and "direct skips", as defined in Code sections 2612(a) and 2612(c), respectively. An ambiguity is present under existing law because a single transfer may be both a taxable termination and a direct skip. For example, assume that spouse A creates a testamentary QTIP trust for the benefit of spouse B (i.e., a trust which qualifies for the federal estate tax marital deduction on spouse A's death by reason of an election under Code section 2056(b)(7)). Assume that no election is made under Code section 2652(a)(3) to treat the property in the trust, for purposes of Chapter 13, as if the QTIP election had not been made under Code section 2056(b)(7). Assume further that on the subsequent death of spouse B, the property in the QTIP trust is to bypass the child of spouses A and B and is instead to be held in further trust for the benefit of the grandchild of spouses A and B. Also assume that since no individual other than the grandchild has an "interest" (as defined in Code section 2652(c)) in the trust, the trust for the benefit of the grandchild is a "skip person" within the meaning of Code section 2613(a).

In the foregoing example, the subsequent death of spouse B constitutes both a taxable termination and a direct skip under current law. It is a taxable termination because the interest of spouse B in the trust has terminated and neither of the exclusions set forth in Code sections 2612(a)(1)(A) and 2612(a)(1)(B) applies. It is a direct skip because it is a transfer, subject to the estate tax, of an interest in property to a trust which falls within the definition of a skip person.

Section 114(f)(3) of the Bill seeks to solve this problem by adding a new paragraph to the end of section 2612(a) directing that the term "taxable termination" shall not include any transfer which is a direct skip.

Accordingly, in the above example treatment as a direct skip would take precedence over treatment as a taxable termination. This result is sensible and has much to commend it.

However, the proposed technical correction is, I believe, deficient in one respect in that it fails to provide a remedy in one specific case. If we vary the above example so that the child of spouses A and B who is the grandchild's parent is deceased at the time of spouse B's death, a technical problem is presented which would lead to the unintended result of the transaction's being treated as a taxable termination. This problem relates to the exception set forth in Code section 2612(c)(2). Under this exception, for purposes of determining whether a direct skip has occurred, a grandchild will be deemed to move up one generation level if his parent who is a lineal descendant of the transferor (or his spouse or former spouse) is dead. Accordingly, if in our example the child of spouses A and B had predeceased spouse B, no direct skip would occur upon spouse B's death when the property passes to or in trust for the grandchild. This exception is necessary to avoid the harsh and unfair result which would occur where a transfer is made to a grandchild not in order to avoid transfer tax at the generation level of the grandchild's parent, but rather because the parent has predeceased the transferor, leaving the grandchild as the natural recipient of the property which the grandchild's parent would have taken if living.

However, in the example cited above, even though the transfer has been excluded from the definition of a direct skip under section 2612(c)(2), it would fall within the definition of a taxable termination, and hence be subject to the generation-skipping transfer tax. This is an unfair result and one which frustrates the intent of Congress, which by creating a specific exclusion from the definition of direct skip where property is transferred to or in trust for a grandchild whose parent is deceased, has evidenced a clear intention that such transfers not be subjected to the generation-skipping transfer tax.

The proposed technical correction under which direct skips are to take precedence over taxable terminations would not cure this result. Since the transfer would not constitute a direct skip because of section 2612(c)(2), the language added by the Bill would be inapplicable and a taxable termination would occur. In fact, under the law as amended by the Bill, there would be the anomalous result that a transfer in trust for the benefit of a grandchild whose parent had died before the transfer would actually be taxed (as a taxable termination) more harshly than would have been the case had the grandchild's parent still been living at the time of the transfer in trust to the grandchild (in which case the transfer would have been taxed as a direct skip rather than a taxable termination). This is because a direct skip is, in general, taxed more favorably than a taxable termination.

It would seem that to be consistent with both the evidenced Congressional intent as well as concepts of fundamental fairness, a transfer such as the example cited above where property in a QTIP trust passes to or in trust for a grandchild on the death of the second spouse should be excluded from the definition of taxable termination entirely and should be tested solely under the direct skip provisions. Accordingly, if the transaction is excluded from being taxed as a direct skip under the predeceased child exception of section 2612(c)(2), the transaction should be entirely excluded from the tax. This should also be true in the case of any other transfer from a trust which may fit the technical definition of a taxable termination but which is also a transfer subject to the estate or gift tax of an interest in property to a skip person (for example, a situation where the grantor of a fully revocable inter vivos trust dies and where the trust corpus then passes to or in continuing trust for the grantor's grandchild).

To accomplish this, I believe that a section 114(f)(3) of the Bill should be amended to read as follows:

"(3) TAXABLE TERMINATION NOT TO INCLUDE DIRECT SKIP.--For purposes of this chapter, the term 'taxable termination' shall not include any transfer which is a direct skip or which would be a direct skip except for the application of section 2612(c)(2)."

Very truly yours,

Ken Slutsky

Kenneth J. Slutsky

KJS:pb

cc: Mary McAuliffe,
Minority Chief of Staff

THE LUTHERAN CHURCH-MISSOURI SYNOD

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Rev. D.D. Schiebinger, PhD
Planned Giving Counselor
Indiana District

M E M O R A N D U M

Date: July 15, 1987

To: U. S. Senate Committee on Finance

From: Dr. D. D. Schiebinger

Re: "Technical" Change in Technical Corrections Act

The "technical" change in the Technical Corrections Act would, if enacted, discourage the creation of many Charitable Lead Trusts. If enacted, it would repeal the charitable deduction in computing the Generation-Skipping Transfer Tax (G. S. T. T.) on lead trusts created after June 10, 1987. If enacted, it would discourage an important source of support for charitable institutions.

I strongly encourage you to keep the charitable deduction in the G. S. T. T.'s "inclusion ratio" formula. The repeal of the G. S. T. T. charitable deduction for lead trusts is clearly substantive and not technical. I strongly protest the repeal of the charitable deduction as an offset against the Generation-Skipping Transfer Tax on charitable lead trusts.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Subcommittee on Taxation and Debt Management
United States Senate Committee on Finance
Public Hearing of July 22, 1987
Concerning S.1350, The Technical
Corrections Act of 1987

The Impact of the
Passive Foreign Investment Company Provisions
on Foreign Operating Subsidiaries of U.S. Multinationals

Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to submit its comments in connection with the Subcommittee's hearing on S.1350, the Technical Corrections Act of 1987 (TCA). Because we are particularly concerned about the impact of the Passive Foreign Investment Company provisions of the 1986 Code on foreign operating subsidiaries of U.S. multinationals, our comments are focused on TCA Section 112(n) and the changes it would make to Code Sections 1291 through 1297. We ask that our statement be entered into the record.

The Passive Foreign Investment Company (PFIC) rules were added to the Code by the Tax Reform Act of 1986 (TRA)./1 It is our view that the PFIC provisions, as enacted, do not reflect Congressional intent because they effectively end deferral for many controlled foreign corporations (CFCs). We believe that in passing TRA, Congress did not intend to subject to current taxation (or the approximation thereof) non-Subpart F income derived by manufacturing, service, and other operating foreign affiliates. Rather, Congress intended to address certain issues related to foreign incorporated investment funds and U.S. persons who are their shareholders. The extension to CFCs of House and Senate bill provisions directed at investment funds was a technical error, which is properly the subject of TCA.

Unless corrected, the PFIC provisions may compromise the competitive position of many U.S. multinationals with foreign affiliate operations, which now may be subject to the Code's PFIC provisions as well as its CFC rules. The CFC rules draw an important distinction between income derived from the active conduct of a trade or business and that derived from passive or tax haven-type investments. To the extent the PFIC provisions apply to CFCs, that distinction, crucial to U.S. multinational operations, is eliminated.

MAPI Interest

As you may know, MAPI is a leading business organization established in 1933 to represent producers and users of capital goods and allied products. Over the years, our membership has expanded to include electronics, telecommunications, office systems, aerospace and other high technology industries, as well.

Most of the Institute's member companies conduct business throughout the world, many through foreign affiliates which fall within the purview of the Code's Subpart F provisions. It appears that many of

1/ Public Law 99-514, 100 Stat. 2085.

these affiliates may also be subject--and we believe unintentionally and inappropriately so--to the PFIC provisions.

Summary of Comments

As already noted, Code Sections 1291-1297 were enacted to subject to current taxation the passive (and capital gains) income of certain foreign incorporated mutual or investment funds which for varying reasons were not subject to the CFC, foreign personal holding company (FPHC), personal holding company (PHC), or foreign investment company (FIC) provisions of the Code.

However, PFICs are so broadly defined and their operating rules are so ill-coordinated with the rules governing CFCs that solutions intended for foreign investment companies may totally disrupt the regime which has for 25 years effectively governed the taxation of U.S. shareholders with respect to their foreign operating affiliates that are CFCs.

While TCA Section 112(n) would correct certain of the more egregious features of the PFIC provisions as they apply to CFCs, it would not cure the most significant problem, which, as previously noted, is the application of the PFIC provisions to CFCs and their U.S. shareholders. Our comments may be summarized as follows:

-- Controlled foreign corporations (defined in Code Section 957) should be excluded from the Section 1296 definition of a PFIC and, at a minimum, U.S. shareholders (defined in Code Section 951(b)), should be excluded from the operation of Section 1291(a).

-- Congress did not intend to eliminate the distinction between Subpart F income which is currently includible in a U.S. shareholder's gross income and non-Subpart F income whose recognition by the U.S. shareholder is subject to deferral.

-- Statutory rules governing the valuation of operating assets for purposes of the Section 1296(a)(2) assets test are inadequately defined.

-- The amendments contained in TCA Section 112(n) reflect Congressional intent except to the extent that they do not exclude CFCs and their U.S. shareholders from the operation of the PFIC provisions.

Following a brief review of the background of TCA, we will elaborate on the comments summarized above.

Background

Controlled Foreign Corporations: A Summary of Pertinent Provisions

Controlled foreign corporations.--Except to the extent the PFIC provisions apply, the tax treatment of U.S. shareholders of CFCs is prescribed by Code Sections 951 through 964 (often referred to as Subpart F). Other Code provisions, of course, also may apply. Significantly, these include the foreign tax credit rules of Subpart A and Section 1248 which concerns the tax treatment of gain derived from certain sales or exchanges of stock in CFCs./2

2/ A number of other Code provisions, such as Sections 881 and 882 concerning direct taxation of foreign corporations, Sections 551 through 558 relating to foreign personal holding companies, and Sections 531 through 537 concerning the accumulated earnings tax, may also apply, but are not germane to this discussion.

Subpart F.--To briefly summarize, U.S. persons owning (directly, indirectly, or constructively) 10 percent or more of the voting power (U.S. shareholders) of a foreign corporation which is more than 50 percent, by vote or value, owned (directly, indirectly, or constructively) by U.S. shareholders (i.e., a CFC), generally, must currently include in gross income their pro rata share of income described in Code Section 951(a) (i.e., "Subpart F" income) derived by the CFC. A component of Subpart F income is "foreign personal holding company income" which is defined in Section 954(c) and includes, generally, dividends, interest, certain rents and royalties, gains from the sale of property which gives rise to such income (or does not give rise to any income), and gains derived from certain commodities and foreign currency transactions.

Generally, under Section 959, Subpart F inclusions, as previously taxed income (PTI), are not taxed again when distributed. When a U.S. shareholder sells or exchanges stock of a CFC, any gain recognized generally is included under Section 1248 in gross income as ordinary, dividend income to the extent of the CFC's earnings and profits that are attributable to the stock and that have not previously been included in income.

Foreign Tax Credit.--Under the "deemed paid" foreign tax credit rules of Section 902 and 960, generally, Subpart F inclusions and dividends in respect of CFCs (and certain other foreign corporations) can carry with them indirect credits for taxes paid by first, second, and third tier foreign subsidiaries. These credits, of course, are subject to the separate limitation and "look through" rules of Section 904.

Passive Foreign Investment Companies:
Definition and Tax Treatment

Definition.--A PFIC is defined in Code Section 1296(a) as any foreign corporation if either (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of, passive income. For these purposes, passive income is defined as income that is includible in the passive income separate foreign tax credit limitation of Section 904(d)(2)(A), without regard to the exceptions to the limitation. Thus, passive income generally includes dividends, interest and its equivalents, passive rents and royalties, and other passive-type income./3

Any U.S. person (without regard to the level of ownership and subject to certain attribution rules) who receives an "excess distribution" in respect of stock in a PFIC or disposes (or is treated as disposing) stock in a PFIC is subject to the special tax regime provided in the PFIC provisions. Total excess distributions are the aggregate amount of distributions received during the taxable year in excess of 125 percent of the average distributions received by the shareholder with respect to the stock during the three preceding taxable years. If more than one distribution is received during a taxable year, total excess distributions (if any) are allocated between them on a pro rata basis.

Tax treatment.--To briefly summarize, two alternative methods of taxation are provided. Under Section 1291(a), the U.S. person receiving an excess distribution or recognizing gain on the disposition of PFIC stock is subject to a deferred tax charge (at the maximum

3/ For purposes of the income and assets tests, a foreign corporation that owns at least 25 percent (by value) of the stock of another foreign corporation is treated as receiving directly its proportionate share of that corporation's income and owning its proportionate share of the assets of that corporation.

corporate tax rates for the years in question) and an interest charge both of which are added to the taxpayer's tax liability for the year of distribution or disposition, with respect to amounts allocated (on a pro rata basis) to each of the PFIC's tax years beginning before January 1, 1987 and the current tax year./4 Amounts allocated to the current tax year and pre-effective date tax years are included in the shareholder's gross income and are treated as ordinary, dividend income.

Alternatively, a PFIC may elect under Section 1293 to be a qualified electing fund (QEF) and its income is then currently includible in the U.S. person's gross income. The U.S. person/shareholder may elect to defer tax on income deemed received from a QEF (subject to an interest charge) until a recognition event occurs (as provided in the statute).

Other rules.--If a PFIC is a QEF and a CFC, the Subpart F rules apply to the extent of income which is Subpart F income. The PFIC rules apply to income in excess of Subpart F income. No similar coordination is provided in connection with excess distributions or gain on disposition in respect of the stock of a PFIC which is not a QEF.

Section 1291(a)(5) provides that the deemed paid credit of Section 902 does not apply to any dividend paid by a PFIC which is not a QEF.

Section 1297(b)(1) provides that stock held by a taxpayer is treated as PFIC stock if, at any time during the holding period of the taxpayer with respect to the stock, the corporation (or any predecessor) was a PFIC which was not a QEF unless the taxpayer elects to recognize gain (as of the last day of the last taxable year for which the company was a PFIC) generally as though the taxpayer sold the stock at its fair market value. Section 1297 also provides rules concerning attribution of ownership, start-up years, certain corporations changing businesses, separate interests treated as separate corporations, and use of stock in a PFIC as security for a loan.

Technical Corrections Act

TCA contains a number of provisions affecting PFICs. These are found in its Section 112(n). Significantly, TCA would repeal Section 1296(a)(5) which denies the Section 902 deemed paid credit to PFICs that are not QEFs and would require excess distributions to be properly adjusted for income previously included in gross income by virtue of Subpart F, the foreign personal holding company rules, and the QEF rules.

Detailed Comments

PFIC Rules Should Not Apply to Controlled Foreign Corporations or Their U.S. Shareholders

The Code's Subpart F (together with Section 1248) and foreign tax credit provisions prescribe a thorough, well-thought-out scheme for U.S. taxation of U.S. shareholders of CFCs. Current taxation is provided with respect to "tax haven" type income. Ordinary income, dividend treatment applies to repatriation in the form of actual dividends or sale and exchange gain treated as dividend income.

4/ TCA would modify Section 1291(a)(1)(B)(ii) to clarify that the deferred tax charge rules apply only to PFIC taxable years which begin after December 31, 1986 and before the taxable year in which the distribution occurs.

This scheme is an effective and balanced mechanism for preserving residual U.S. taxation while properly limiting the reach of U.S. tax jurisdiction as it touches foreign source income and particularly foreign source operating income. CFCs should be excluded from the PFIC provisions because the CFC rules adequately protect U.S. tax jurisdiction. In our view, neither U.S. tax policy nor U.S. trade policy is served by grafting onto the CFC provisions a new regime which lacks the balance of the CFC rules in that it fails to account for the crucial distinction drawn in Subpart F between income derived from the active conduct of a trade or business and that derived from passive, tax haven-type investments.

Congress Did Not Intend To End Deferral For CFC Non-Subpart F Income

In our view, the legislative history of the PFIC provisions reveals that Congress did not intend to subject U.S. shareholders of CFCs to the PFIC provisions.

Both the House and the Senate bills contained provisions aimed at curing certain perceived abuses related to foreign incorporated investment funds. Generally, U.S. shareholders of such funds were viewed as avoiding current U.S. taxation on passive, tax haven-type income, because either the ownership of the fund was too widely dispersed to invoke the foreign personal holding company rules or the level of a U.S. shareholder's ownership or aggregate ownership by U.S. persons was not high enough to come within the ambit of the Subpart F rules. Similarly, the Section 1246 foreign investment company rules, which require ordinary income treatment on gains from the sale of stock, could be avoided by limiting the percentage of ownership by U.S. persons.

The House bill would have treated any foreign corporation meeting its PFIC test (generally that described in Section 1296) as a CFC, regardless of the proportion of U.S. ownership or the percent of stock held by a particular person. The Senate bill would have subjected PFICs (as now defined in Section 1296) to a special regime, largely similar to the present law PFIC rules, but would have exempted U.S. shareholders of CFCs from the application of the PFIC provisions and would have permitted any taxpayer subject to the PFIC rules to elect to be treated as a U.S. shareholder of a CFC and to be taxed under the CFC rather than the PFIC rules.

Thus, under either bill, U.S. shareholders of CFCs would not have been subject to the PFIC rules and the impact of the PFIC rules would have been limited as intended to offshore investment funds.

— Conference agreement.--The conferees on the Tax Reform Act, working with summary descriptions of the two bills, adopted, generally, the Senate version. This action was reported by a Joint Committee on Taxation summary of August 16, 1986 which stated, in pertinent part, "Generally, House recedes but with restrictions (including requirement that foreign fund furnish information) on identification of income and flow-through of income character and with technical modifications." On August 29, 1986, the Joint Conference Agreement (JCS-16-86), stated, in pertinent part, "Present law is amended to require either payment of an interest charge on eventual recognition of income earned by U.S. investors through passive FICs (subject to a gain limitation) or current recognition, and to apply these rules to U.S. investors irrespective of the degree of aggregate U.S. ownership. . . ." (Emphasis supplied.)

Neither release revealed that the language of the PFIC provisions of the Senate bill had been so thoroughly--and we believe erroneously--redrafted as to effectively end deferral for many CFCs. The Conference Report on the Tax Reform Act of 1986, consisting of statutory language and an explanation (H.Rept. 99-841), was released on

September 18. The measure was passed by the House on September 25 and the Senate on September 27.

Tax Reform Act.--As passed, TRA contained substantial errors, many of which are still being identified. We do not believe that Congress knew, or was able to know, that the PFIC rules contained in the bill would apply to U.S. shareholders of CFCs and would have the effect of ending deferral for many CFCs.

The Institute firmly believes that the Subpart F regime should be retained. Enacted in 1962 and modified several times since, it is an effective, generally balanced mechanism for taxing U.S. shareholders on income related to foreign subsidiary operations. Part of its balance lies in the distinction it draws between passive, tax haven-type income and operating income, should be retained. It is a balance which Congress, on addressing the issue directly, has chosen not to disturb./5 Congress could have, and did not, take up the issue of ending deferral in considering the CFC provisions included in TRA. Moreover, taxpayers did not have the opportunity to comment on provisions which fundamentally change the long-standing mechanisms governing U.S. taxation of CFC operations prior to enactment of those rules.

If the Subpart F regime is to be modified, Congress should have the opportunity to confront head on the issues such action would entail. Congress has not had that opportunity in connection with the PFIC provision as extended to CFCs. This, in our view, is an error which occurred as part of the TRA drafting process and, thus, its correction warrants inclusion in TCA.

Valuation for Purposes of
Assets Test of Section 1296(a)(2)
Should Be Defined

Most CFCs which would be PFICs by virtue of the income test, which has a 75 percent passive income threshold, would also be subject to the 70 percent full inclusion rule of Subpart F./6 By contrast, many CFCs with substantial non-Subpart F income may be subject to the PFIC rules if "the average percentage of assets (by value) held by such corporation during the taxable year which produce passive income . . . is at least 50 percent." (Section 1296(a)(2)) The test is not further defined in the statute or in the legislative history. Similarly, TCA, as introduced, would provide no further elaboration.

In the context of an investment fund, the assets test may be fairly easy to apply because such a fund's assets would consist largely of cash, securities, and their equivalents. In the context of an operating company, however, valuation is far more complex. The statute does not indicate whether fair market value, book value, or net book value applies. No guidance is given regarding the treatment of assets such as trade receivables, manufacturing intangibles, "going concern" value, goodwill, contracts, and the like. This raises the specter of unreasonable uncertainty. Further, it offers the Internal Revenue Service wide-ranging opportunity to sweep many CFCs which have substantial operating income into the PFIC net.

5/ In connection with the Tax Reform Act of 1976, the Carter Administration proposed eliminating deferral with respect to non-Subpart F income. The proposal was not adopted by Congress.

6/ The income which enters into the 75 percent PFIC income test and that which enters into the 70 percent Subpart F test differ in several respects, although the key common element is foreign personal holding company income.

TCA Section 112(n) Reflects Congressional Intent Except to the Extent That It Would Not Exclude U.S. Shareholders of CFCs From the PFIC Provisions

TCA Section 112(n) would modify the PFIC provisions in several respects which, in our view, are consistent with the provisions' legislative purposes. In particular, the section includes two crucial amendments. Section 112(n)(7) would repeal Section 1296(a)(5) which denies the Section 902 deemed paid credit to PFICs which are not QEFs. Section 112(n)(3) would require excess distributions to be properly adjusted for income previously included in gross income by virtue of Subpart F, the foreign personal holding company rules, and the QEF rules.

These amendments would limit the double taxation that almost certainly will result from the application of the PFIC provisions to CFCs. They are not, however, sufficient to cure the totally inappropriate imposition of PFIC taxation on U.S. multinationals that are U.S. shareholders of CFCs, which have substantial operating income or which are holding companies for second (or lower) tier operating subsidiaries. As we have urged above, the Subpart F tax regime ensures that any significant amounts of passive income generated by such companies are taxable currently at the U.S. shareholder's level. When confronted with the issue of ending deferral with respect to CFC operating income, Congress has chosen to retain it. Injudicious drafting of provisions not directed at operating CFCs should not change this result.

Conclusion

Considerable congressional attention has been given to the issue of the competitiveness of American business in global markets. One obvious element of competitiveness is cost. And, one element of cost is taxes. To the extent U.S. multinational businesses bear greater aggregate burdens of taxation than do similiarly situated foreign multinationals, their ability to compete is compromised.

The Code's CFC provisions represent, in part, an effort to level the playing field. U.S. shareholders are taxed on their investments in CFC operations only when they earn certain types of income (generally passive and moveable in nature) or when they receive a return on their investments in the form of dividend payments or gain on disposition. This is as it ought to be.

The PFIC provisions, incorrectly and we think unintentionally, slant the playing field by effectively eliminating or penalizing deferral and Congress has not had the opportunity to confront the issue of whether this serves this country's trade or tax policy interests. An effort to plug an investment fund leak may sink the reliable, well-tuned approach to taxing U.S. multinationals' CFC operations.

We hope that our comments will prove useful in the Committee's consideration of TCA. Should there be any questions or if we can be of assistance, please contact us.

MARINE MIDLAND BANK, N.A.
140 Broadway
New York, New York 10005

GORDON F. MARTIN
Administrative Vice President
and Director of Taxes
(212) 440-1417

July 6, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

S 1350/HR 2636 "Technical Corrections Act of 1987"

Special NOL carryback provision for NOLs of commercial banks attributable to bad debt deductions

Dear Ms. Wilcox:

Section 903 of the Tax Reform Act of 1986 amended §172(b) of the Internal Revenue Code to provide that, in general, a net operating loss of a commercial bank would be carried back three years and forward fifteen years as is generally the case with all other taxpayers. Congress's reason for providing such a rule was that the net operating losses of commercial banks should be treated in the same manner as that of all other taxpayers, H. Rep. 99-426, pp.592. See also, General Explanation of the Tax Reform Act of 1986 ("Blue Book") at pp.567.

The bill enacted differed from the House proposal by providing an exception to the general rule of "back 3, forward 15". The exception is that for taxable years beginning before January 1, 1994, an NOL is carried back ten years and forward five years to the extent it is attributable to a bad debt deduction. While the Conference Report does not explain Congress's reason for providing such a exception, the Blue Book states, at pp.567:

Reasons for Change

> The Congress believed that net operating losses incurred by financial institutions, such as commercial banks and thrift institutions, should

be treated in the same manner as net operating losses incurred by other taxpayers. However, the Congress was aware that the immediate application of such a change to commercial banks in concert with the repeal of the reserve method of computing a deduction for bad debts could have an unnecessarily adverse impact upon the deferred tax accounts that such taxpayers keep for financial and regulatory accounting purposes. Accordingly, the ten year carryback period of prior law is retained for such taxpayers for taxable years beginning before 1994 for the portion of a net operating loss attributable to deductions for bad debts.

While Congress may have intended to fashion an exception which benefits a handful of banks, it may not have fully understood the attendant cost. Such a rule adds unnecessary, unwieldy, and unconscionable administrative complexities not only upon commercial banks who did not lobby for such a rule, but also upon IRS officials who will have to track NOLs from the single year of incurrence along two separate carryback tracts.

The Code does not provide ordering rules where the portion of a 1987 NOL carried back ten years frees credits which may be carried forward to the year in which the balance of the NOL is carried back three years. This is but a hint of the complexity. Indeed, the application of a similarly bifurcated alternative minimum tax net operating loss deduction will doubtlessly result in still further complexity.

Therefore, I respectfully request that taxpayers be allowed to treat an entire net operating loss consistently by electing that the entire net operating loss be carried back three years.

Very truly yours,

Gordon F. Martin
Administrative Vice President
and Director of Taxes

Before the
Committee on Finance
United States Senate

Re: Technical Corrections Act of 1987, H.R. 2636

STATEMENT OF IRA A. BIRD, VICE
PRESIDENT-FINANCE OF MARINE TRANSPORT LINES, INC.

My name is Ira A. Bird. I am Vice President-Finance of Marine Transport Lines, Inc. (MTL), whose main corporate offices are located in Secaucus, New Jersey.

MTL operates more than 60 vessels in foreign oceanborne commerce, fifteen of which are United States flag. We were the first American company to contract for a United States-flag vehicle carrier. That vessel, the MARINE RELIANCE, chartered by a wholly owned subsidiary of MTL was delivered to our company on June 22, 1987.

Ironically, although we were the first American company to contract for a United States-flag vehicle carrier, our vessel is the only one of the four such vessels that has been excluded from transition rule relief for preserving the investment tax credit. This exclusion is clearly the result of an oversight.

At the naming ceremony of the MARINE RELIANCE, at the Oppama shipyard of Sumitomo Heavy Industries, Mike Mansfield, the United States ambassador to Japan stated that the vessel was

> "...a fine example of the willingness of Japanese and American businesses to work together... I hope that the cooperation can help lessen some of the trade tensions that exist between the United States and Japan."

We are aware of the Committee's intention to limit matters in the Technical Corrections Act to those items that are legitimately "technical corrections and clarifications." The matter covered by this testimony falls within that category, and we believe it involves a situation that is <u>sui generis</u> under the Tax Reform Act.

The omission of MTL's vehicle carrier in the transition rules either in the Tax Reform Act or in the Technical Corrections

Act, which cover three other United States-flag vehicle carriers, involves a clear and unfortunate oversight. This oversight was the result of what appears to be confusion and misunderstanding as to how many identically situated United States-flag vehicle carriers were being built by American companies. It seems clear that the Conferees on the Tax Reform Act and Congress intended to include all of the identically situated vessels in the transition rule relief. There would have been no logical reason to do otherwise. The facts are as follows:

During 1985, three Japanese automobile manufacturers undertook negotiations with various American companies concerning the chartering of United States-flag vehicle carriers for the important Japanese/United States automobile trade. These negotiations were the outcome of intense pressure that had been put on the Japanese by American union interests, Senator Murkowski, and by the House Merchant Marine and Fisheries Committee, which had introduced legislation (H.R. 3655) to require the presence of some United States-flag vehicle carriers in this trade. Even though the United States is the largest market for Japanese automobiles and the United States consumer pays the cost of transportation, the Japanese automobile manufacturers, who control the routing of automobiles, had never previously agreed to employ a United States-flag vehicle carrier in this trade.

There were three American companies involved in the construction and chartering of the four United States-flag vehicle carriers. MTL signed a charter contract with Nissan Motor Car Carrier Co. on February 20, 1985 and a shipbuilding contract with Sumitomo Heavy Industries on December 30, 1985. Subsequently, Central Gulf Corporation entered into similar contracts for two vessels and Maritime Overseas Corporation for one vessel with Japanese shipbuilders and Japanese automobile manufacturers.

In June 1986, as the Tax Reform Act proceeded through the Senate, it became apparent that all of these vehicle carriers would need transitional rule relief under the Tax Reform Act in order to be assured of the investment tax credit. The cut-off date in the then proposed legislation for preserving the ITC had by that time been established for binding contracts entered into before January 1, 1986. Although MTL had entered into a shipbuilding and a transportation contract prior to January 1, 1986, it may be arguable that the shipbuilding contract did not become binding within the meaning of the Tax Reform Act until after January 1, 1986. We do not think that it would be fair to have any question with IRS concerning the availability of the ITC for MTL's vehicle carrier. All of the three companies and all of the four vessels should be considered as identically situated for purposes of ITC treatment under the Act. There would have been no reason to exclude one or two of the vessels from ITC relief or to treat any of the vessels differently from one another under the Act. We are convinced that Congress did not so intend.

The root of the problem relating to MTL can be found in a memorandum from Senator Frank Murkowski to then Senate Finance Committee Chairman Packwood, dated June 18, 1986. In this memorandum, Senator Murkowski stated the following concerning a transition rule for the vehicle carriers:

> "The phase out of the Investment Tax Credit is January 1, 1986. Only one of the car carrier contracts was actually executed before that date. Three other contracts were executed in late January, and in May 1986.
>
> However, negotiations leading to the three post-January 1 contracts consumed literally months of effort, and in all cases agreements in principle were struck in late 1985 or early 1986.
>
> The availability of current investment tax credit law played an integral part in enabling the US firms to compete for the carrier contracts. The credits are intended to offset costs that the Japanese were unwilling to bear, including workers' compensation expenses."

Senator Murkowski's understanding that only three of the vessels needed transition rule relief was unfortunately incorrect. A similar misunderstanding existed initially in the House Merchant Marine and Fisheries Committee. Representatives of MTL and National Marine Engineers Beneficial Association (NMEBA) moved immediately to correct the record and to point out that there were four vessels that needed the ITC relief. The following documents reflect these efforts:

1. A letter, dated August 7, 1986, from the leadership of the House Merchant Marine and Fisheries Committee to Chairman Rostenkowski (and to other House conferees) in which it was pointed out that there were four vehicle carriers that needed ITC relief--not three--as the Committee had originally understood.

2. Letters, dated August 21, 1986, from C.E. DeFries, President of NMEBA, to Senator Russell Long and to each Senate conferee pointing out that there were four vessels involved and that it would be unfair to treat any of them differently.

Representatives of NMEBA and MTL were led to believe by Senator Long's office that he would introduce at the Conference a transition rule covering all four vehicle carriers. The House Conferees were prepared to accept what Senator Long would introduce. At the Conference, Senator Long introduced a transitional rule covering only the two Central Gulf vehicle carriers.

Until the Conference Report became available in August 1986, the oversight was not discovered by MTL or NMEBA. The closing days of the legislative session were hectic, and it was difficult to speak to any Conferee or to any of the Committee staff members or to have them focus on this issue. Clearly, however, the inclusion of only two vessels rather then four in the Conference Committee Report (Page I-79) was an oversight.

Several additional attempts to remedy the oversight were made including:

1. Letters, dated October 2 and October 7, 1986, to Chairman Packwood and to Senator Matsunaga from Senator Frank Murkowski pointing out that there was "confusion" over the number of vessels which needed transition rule relief and that there were four vessels instead of three, as he had originally assumed;

2. A letter dated October 7, 1986, from Senator Murkowski to Senator Lautenberg and Senator Bradley;

3. A letter, dated October 11, 1986, from Chairman Walter Jones of the House Merchant Marine and Fisheries Committee to Chairman Dan Rostenkowski pointing out that the Committee's previous letter of August 7, 1986 dealing with the transition rule was apparently misplaced and not made available to the House Conferees;

4. A colloquy set forth on the Senate floor on Friday, October 17, 1986 between Senator Packwood and

Senator Lautenberg during which Senator Lautenberg stated and Senator Packwood acknowledged that there had been an unfortunate oversight with respect to MTL; and

5. A letter dated March 9, 1987 from Chairman Jones to Chairman Rostenkowski reviewing again the oversight that had occured and urging him to support an amendment for the MTL vessel in the Technical Corrections Bill.

Differing treatment for any of these four identically situated vehicle carriers was clearly not intended by Congress. There were a number of circumstances that contributed to the oversight. First, there was an original understanding by Senator Murkowski and the House Merchant Marine and Fisheries Committee that the MTL vessel did not need transitional rule relief. Second, there was an understanding by those involved, including the Merchant Marine and Fisheries Committee, that Senator Long would introduce a transition rule for four vessels. Third, attempts to correct the initial misunderstanding concerning the number of vessels involved were unexplainably frustrated, including the apparent misplacement of the August 7, 1986 letter from the Merchant Marine and Fisheries Committee. It seems obvious that the Conferees and the Congress intended to include all of the vehicle carriers that required transitional rule relief in the rule. The colloquy between Senators Lautenberg and Packwood on the Senator floor on October 17, 1986 eloquently attests to the fact that an oversight occurred. That colloquy is attached as an Appendix.

It is understood that the vehicle carrier to be owned by Maritime Overseas Corporation, or a nominee thereof, is included in the Technical Corrections Act. The amendment needed to include the MTL vehicle carrier is as follows:

(P) The amendments made by section 201 shall not apply to a new automobile carrier vessel to be registered under the United States-flag, the construction contract and charter for which were negotiated during 1985 and a binding construction contract, not to exceed $22,000,000, was entered into before June 1986 by Marine Car Carriers, Inc., which vessel will be used to transport vehicles in the foreign waterborne commerce of the United States and in other international commerce.

Attachment

there has been objection offered to it and it has been indicated there would be no more rollcall votes. If this were pushed, it would require a vote. As strongly as I do support it, I feel the bill cannot go anyplace as long as the amendment is left on it.

Mr. MOYNIHAN. Mr. President, in the circumstances, it having been announced that there will be no more rollcall votes, I do withdraw the amendment reluctantly.

The PRESIDING OFFICER. The Senator has that right.

The amendment (No. 3498) was withdrawn.

Mr. PACKWOOD. Mr. President, I have a series of different colloquies involving the tax bill which have been cleared on both sides. I ask unanimous consent that the colloquies be entered into the RECORD as if given.

The PRESIDING OFFICER. Without objection, it is so ordered.

GENERAL AVIATION TRANSITION RULE

Mr. ROTH. Mr. President, the Packwood amendment to House Concurrent Resolution 395 would have that provision dealing with new airplanes with 19 or fewer passenger seats contained in sec. 204(a)(11) of the enrolled tax bill (H.R. 3838) apply to all such airplanes "manufactured at the point of final assembly in the United States".

I have a question I would like to pose to the distinguished manager of the resolution. Is it his understanding that the expression "manufactured at the point of final assembly" would apply to airplanes initially constructed overseas to which firms located in my State add 10 percent or more value through the installation or completion of a portion of the avionics; interior finishing process including seats, tables or carpeting; inside or outside lighting; exterior painting; and windows and their component parts?

Mr. PACKWOOD. Yes, that is my understanding. I want to make it clear that this does not mean that a foreign manufacturer could simply fly a completed airplane to the United States, tighten some screws, and claim that the "point of final assembly" for the aircraft is in the United States. What we have in mind with this rule is that at least 10 percent of the value of the airplane must be added in the United States.

Mr. BUMPERS. May I ask the chairman whether this 10 percent value added must all be added at the "point of final assembly" or whether some of this U.S. value may be added through U.S. suppliers? For example, I understand that certain aircraft manufacturers use U.S.-made engines, but these engines are first flown to manufacturing facilities abroad to be attached to the airplanes. The airplanes then are flown to the United States where more U.S. value is added at the point of final assembly. The result is that substantially more than 10 percent of the value added and domestic content of the airplanes made by these companies is from U.S. workers at the point of final assembly and from U.S. suppliers in many States at many points in the assembly process. My question is whether this meets the requirement that 10 percent of the value added be in the United States.

Mr. PACKWOOD. My answer is yes. It makes no difference whether all the 10 percent U.S. value added is added at the "point of final assembly" or whether some of it is added to the airplane earlier in the manufacturing process, as for example, by the installation of U.S.-made engines during the assembly done abroad.

Mr. BOREN. Mr. President, I am very pleased that a transition rule of significant help to the economic development of eastern Oklahoma was included in this concurrent resolution. It was intended that it be originally included in the text of H.R. 3838. Oklahoma Industries has been planning for a long time to undertake this project using tax exempt bonds in order to qualify for lower cost financing as a part of an urban development action grant. This new chicken processing plant would provide 800 jobs for Le Flore county which is suffering from severe unemployment. The grant process has been held up because of the indecision surrounding this tax exemption. I appreciate the assistance of the chairman in helping to clear up this matter. This action will be good news to eastern Oklahoma and to so many who want a chance to work and support their families in these very difficult times in our State.

There is a second provision in this concurrent resolution of importance to Oklahoma, the expansion of the ITC exemption for aircraft assembled in Oklahoma City. My colleague from Arkansas, Mr. BUMPERS, has explained the general purpose of this modification and I am delighted that the Oklahoma facility where British Aerospace assembles its planes has been included.

Specifically, British Aerospace has a facility in Oklahoma City, operated by AAR, where it prepares airplanes for final delivery including modifying planes for customers, installing air conditioning and baggage parts and painting the aircraft. In addition, the planes assembled there use U.S. engines manufactured by Garret Turbine Engine Co. in Arizona.

This Oklahoma facility is a "point of final assembly" within the meaning of the transition rule and substantially more than 10 percent of the value of the aircraft comes from U.S. suppliers, the Garrett and U.S. labor at the AAR facility. In short, by extending the reach of this transition rule to all 50 States, the chairman of the Finance Committee has extended the rule to include the airplanes assembled at the Oklahoma City facility for British Aerospace.

Mr. LAUTENBERG. Mr. President, I would like to address a question to the distinguished chairman of the Finance Committee dealing with a matter we discussed earlier this week.

It deals with what I consider a real and obvious unfairness in the measure before us. It has to do with certain transition rules for the investment tax credit. What we have are three U.S. shipping firms. They will compete in the exact same market—the Japan-United States auto trade. Each firm has a contract to purchase new car carrying ships.

I discussed with the chairman an amendment I intended to offer that would make sure that each firm would get the same transition relief. The amendment related to the Japan-United States auto trade. The Japanese have exported millions of automobiles to the United States. They use some 80 to 90 ocean going vessels to ship those cars. But, the Japanese never used United States-flag ships. One third of those vessels have been Japanese-flag ships. The rest have been flags of convenience. But, never U.S. flags.

Then, Mr. President, the Congress brought pressure. And the Japanese Government, and the Japanese automakers responded. The automakers agreed to use four U.S.-flag ships. That's a modest concession, when you consider that they use 20 times that many ships. But, it was a welcome concession. It means an important toehold in a major market. It means jobs for U.S. merchant seamen. And, by breathing life into the U.S. merchant marine, it means enhanced U.S. national security.

Those four U.S.-flag ships are being built now. They're being built pursuant to contracts with three U.S. shipping firms. Two of the ships are being built for Central Gulf Corp. of New Orleans. One is being built for Maritime Overseas Corp. of New York. And one is being built for Marine Transport Lines of New Jersey.

The ITC for Central Gulf's ships is protected by H.R. 3838. The ITC for Maritime Overseas' ship would be protected by the resolution before us. But, the ITC for Marine Transport would not be protected.

That's unfair. There are three firms, in the identical situation. They will all compete in the same market. If preserving the ITC makes sense for one, it makes sense for all.

If we impair the ability of one firm to compete, we risk undermining our efforts to open up a market with the Japanese. We risk undermining our own credibility.

The fact is that without the ITC, operation by MTL will be uneconomic. It might be forced to back out of its contract. If that happened, the United States would be embarrassed and we would be handing the Japanese an excuse to turn away from United States shipping firms.

Mr. President, the problem is that the Finance Committee staff says that they were never made aware of the need for transition relief for Marine Transport. I, for one, was not contacted by representatives for the shipping firm until last week. They relied upon contacts they made on the House side. The union, which wants the jobs, made their own efforts in the Senate and the House.

The bottom line is that the chairman considers this a new item. And, as I understand the chairman, there are many other Senators with new items. If he opens the door for one, he would feel compelled to open the door for others. If he amends his unanimous-consent agreement to allow an amendment to add one, he would have to amend it to allow amendments for others. There is no time for that. The concurrent resolution would die, and many necessary, clarifying changes of a technical nature would die with it.

Mr. President, I do not intend to kill the resolution. However, I would like to put my concern on the record and to seek a response from the chairman.

Mr. PACKWOOD. Mr. President, the Senator from New Jersey is right. We simply cannot accommodate his amendment, without opening the door to others. However, as we have discussed this matter privately, I do want to say that he raises a justified complaint. There is no fair reason why one of the four ships should be denied relief granted to the remaining three. It puts the shipping firm at a competitive disadvantage. I certainly would not want to impair our efforts to get more U.S.-flag vessels in the Japan-United States auto trade. For that reason, I want to say to the Senator from New Jersey that I look forward to working with him next year to address his concerns.

Mr. LAUTENBERG. Mr. President, I thank the chairman. I regret that this matter was not brought to our attention earlier, so that it might have been included this year. But, I accept his commitment to address the matter next year, and I look forward to working with him to ensure that all three competitors are treated the same.

Mr. President, for the sake of the record, I ask unanimous consent that certain documents pertaining to this matter be printed in the RECORD.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

NATIONAL MARINE ENGINEERS'
BENEFICIAL ASSOCIATION,
Washington, DC, October 14, 1986.

Hon. FRANK R. LAUTENBERG, U.S. SENATE,
Senate Hart Office Building,
Washington, DC.

DEAR SENATOR LAUTENBERG: I want you to know that you have MEBA's wholehearted support in your endeavor to correct an oversight in the tax reform bill in regard to transitional rules for car carrier contracts.

The Marine Engineers Beneficial Association has been at the forefront in efforts to persuade the Japanese automobile manufacturers and the Japanese government to employ a reasonable number of United States-flag vehicle carriers in the important Japan/United States automobile trade. Although the United States is the most important market for Japanese automobiles, it has provided no employment for American seamen. This has taken place despite the fact that we permit more than 2.3 million Japanese automobiles to arrive in the U.S. annually—*all* on Japanese-controlled car carriers.

Three Japanese automobile manufacturers have agreed to charter four United States-flag vehicle carriers for this trade. This is nothing short of a revolution in Japanese trade practices, but it also signifies that we are able now to offer service every bit as efficient as one of our major foreign competitors. Each of the four charters was negotiated during 1985, and charter contracts and construction contracts were consummated before July 31, 1986. The companies—Central Gulf Lines of New Orleans, Louisiana; Maritime Overseas Corporation of New York, New York; and Marine Transport Lines of Secaucus, New Jersey—assumed the availability of the investment tax credit in working out the charter rates and the financing.

Because of an apparent oversight, the transition rules and the concurrent resolution to correct oversights, which passed the House of Representatives, includes only three of these vessels—even though they are all similarly situated and they all need the transition rule relief. The carrier contract for Marine Transport Lines was omitted. The consequences of omitting one vessel could adversely impact the American Merchant Marine and render the omitted vessel uneconomic in a very competitive market.

As matters now stand only three of the four vessels are included in the transition rule and in the Concurrent Resolution (H. Con. Res. 395) to correct technical errors in the enrollment of H.R. 3838. The Conference Report to accompany H.R. 3838 (Page I-79) includes only two vessels. The House concurrent resolution adds one additional vessel.

I strongly support your efforts to correct this oversight by including the fourth vessel in the concurrent resolution to correct technical errors that is now before the Senate. Your amendment is essential for badly needed jobs in our merchant fleet. It is important as well in the interest of fairness to all U.S.-flag carriers about to enter this new market.

With kind personal regards.

Sincerely,

C.E. DEFRIES,
President.

KOHRS & KIRCHNER,
Washington, DC, October 7, 1986.

Hon. FRANK R. LAUTENBERG,
Hart Senate Office Building,
Washington, DC.

DEAR SENATOR LAUTENBERG: As the attorney for Marine Transport Lines, Inc. (MTL), which has its headquarters in Secaucus, New Jersey, I should like to call to your attention a gross inequity that now exists in the transition rules to accompany the Tax Reform Act, and to request your assistance. MTL is a United States shipping company which owns or operates more than 50 ships in various bulk trades in international oceanborne commerce.

The transition rule that affects MTL would preserve the investment tax credit for certain United States-flag vehicle carriers, for which construction contracts and charters were negotiated during 1985 and concluded prior to June 1986. During that period, three Japanese automobile manufacturers agreed to charter four United States-flag carriers for use in the Japan/United States automobile trade. MTL had the honor of being the first United States company selected by a Japanese automobile manufacturer.

The contracts that were concluded for the MTL vessel were the result of more than one year of planning and effort. This agreement by the Japanese automobile manufacturers to charter four United States-flag vessels represented a significant breakthrough. Even though the United States is the largest market for Japanese automobiles and the United States consumer pays the cost of transportation, the Japanese automobile manufacturers, who control the routing and choice of ocean carriers, had never previously agreed to employ a United States-flag vehicle carrier in this.

Because of an apparent oversight at the staff level, the transition rules and the concurrent resolution to correct oversights, which passed the House of Representatives, includes only three of these vessels—even though they are all similarly situated and they all need the transition rule relief. Ironically, even though MTL was the pioneer in this effort, the MTL vessel was the one omitted. The consequences of omitting one vessel could be damaging to the American Merchant Marine and render the omitted vessel uneconomic in a very competitive market. This inequity should not be left for technical correction by the next Congress. Let me undertake to explain why the case is sui generis.

During 1985, three American companies (MTL, Central Gulf Corp. and Maritime Overseas Corp.) negotiated independently with individual Japanese automobile manufacturers for the construction and charter of four new vehicle carriers to be registered under the United States flag. Because this was considered a breakthrough for the American Merchant Marine, the companies were willing to negotiate contracts that were only marginally profitable. In order to obtain the vessel financing, each company was required to guarantee the availability of the investment tax credit that existed under the Internal Revenue Act at this time. The availability of the ITC was considered essential to the economic feasibility of the contracts. These credits were intended to offset costs that the Japanese automobile manufacturers were unwilling to bear, including workers' compensation expenses.

In the consideration of a transition rule to preserve the ITC for these vessels, there has been some confusion over the number of vessels that need such a rule. The language for the transition rule covering vehicle carriers was sent to Senator Packwood by Senator Murkowski. It was understood that the rule would be introduced by Senator Long at the conference on the Tax Reform Act. Central Gulf Corporation, which contracted for two vessels, is a constituent of Senator Long. Although Senator Murkowski's office was fully aware that the Japanese had concluded arrangements to charter four United States-flag vehicle carriers, it was Senator Murkowski's understanding that only three of the vessels required protection under the transition rule because contracts for the MTL vessel had been concluded prior to January 1, 1986. Unfortunately, Senator Murkowski's understanding was incorrect. All four of these vehicle carriers require the benefits of the transition rule.

The fact that all four vessels require the transition rule was made clear to each of the Senate and House conferees on H.R. 3838 but not to Senator Murkowski's office. On August 7, 1986, the leadership of the House Merchant Marine and Fisheries Committee sent a letter (copy enclosed) to Chairman Rostenkowski and to each of the other House conferees pointing out that there were four vehicle carriers that were similarly situated which should receive the same protection under a transition rule concerning the investment tax credit. On August 27, 1986, the president of the National Marine Engineers' Beneficial Association wrote a letter (copy enclosed) to each of the Senate conferees pointing out this same circumstance and urging that the transition rule include all four vessels. As far as I am aware, the House and Senate conferees intended to treat all of these vessels alike and that the failure to include all of the vessels in the transition rule was clearly an oversight at the staff level.

As matters now stand only three of the four vessels are included in the transition rule and in the Concurrent Resolution (H. Con. Res. 395) to correct technical errors in the enrollment of H.R. 3838. The Conference Report to accompany H.R. 3838 (page I-73) includes only two vessels:

(c) SPECIAL AUTOMOBILE CARRIER VESSELS.—The amendments made by section 201 shall not apply to two new automobile carrier vessels which will cost approximately $47,000,000 and will be constructed by a U.S.-flag carrier to operate, under the U.S. flag and with an American crew, to transport foreign automobiles to the United States, in a case where negotiations for such transportation arrangements commenced in April 1985, formal contract bids were submitted prior to the end of 1985, and definitive transportation contracts were awarded in May 1986.

The concurrent resolution adds one additional vessel:

(F) The amendments made by section 201 shall not apply to a new automobile carrier vessel, the contract price for which is no greater than $28,000,000 and which will be constructed by Maritime Overseas Corporation to transport, under the United States flag and with an American crew, foreign automobiles to North America in a case where negotiations for such transportation arrangements commenced in 1985 and definitive transportation contracts were awarded before June 1986.

I am aware that a number of technical corrections will have to be made in the Tax Reform Act by the next Congress. However, it is important that this oversight should not be left for such action—it should be corrected by including the fourth vessel in the concurrent resolution to correct technical errors that is now before the Senate. If no action is taken on this vessel at this time, it is possible that a decision may be made not to register the vessel under the United States flag. This would be disastrous for the American Merchant Marine and to our national security.

Therefore, I request that you urge Senator Packwood to correct the above oversight, and to include in the concurrent resolution the following transition rule for the vehicle carrier that has been omitted.

The amendments made by section 201 shall not apply to a new automobile carrier vessel, the contract price for which is no greater than $22,000,000 and which will be constructed by Marine Transport Lines, Inc. to transport, under the United States flag and with an American crew, foreign automobiles to North America in a case where negotiations for such transportation arrangements commenced in 1985 and definitive transportation contracts were awarded before June 1986.

Sincerely,

RICHARD W. KURRUS.

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON MERCHANT MARINE AND FISHERIES,
Washington, DC, August 7, 1986.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR DAN: Reference is made to our letter to you of July 22, 1986, (copy enclosed) concerning a transition rule for automobile carriers that will be offered during the conference on H.R. 3838 by Senator Russell B. Long.

As stated in that letter, Senator Long's proposal would retain the investment tax credit for three United States-flag vehicle carriers which will be constructed for United States companies and will be used to transport vehicles from Japan to the United States.

Senator Long's proposed transition rule assumes that there are only three vehicle carriers involved in this situation which should be protected insofar as the investment tax credit is concerned. We are now informed that there are four vehicle carriers that are all similarly situated and should receive the benefit of the transition rule. Therefore, in order to treat all companies that come within the intent of Senator Long's transition rule alike, we request that you support the following proposed transition rule:

PROPOSED AMENDMENT: "AUTOMOBILE CARRIERS"

At page 1518, line 12, add the following as number "(24)" and renumber the ensuing transition rules:

"(24) SPECIAL AUTOMOBILE CARRIER VESSELS.—The amendments made by Section 201 shall not apply to four (4) vehicle carrier vessels which will be constructed by or for United States companies at a total cost of approximately $94,000,000 under transportation contracts that were negotiated during 1985 and were consummated prior to June 30, 1986; the vessels that are subject to this rule shall be documented under the laws of the United States, comply with United States manning laws, and be used to transport vehicles in the foreign commerce of the United States.

Sincerely,

WALTER B. JONES,
Chairman, Committee on Merchant Marine and Fisheries.

ROBERT W. DAVIS,
Ranking Minority Member, Committee on Merchant Marine and Fisheries.

MARIO BIAGGI,
Chairman, Committee on Merchant Marine.

GENE SNYDER,
Ranking Minority Member, Subcommittee on Merchant Marine.

NATIONAL MARINE ENGINEERS' BENEFICIAL ASSOCIATION,
Washington, DC, August 27, 1986.

Re: Transition Rule for Certain United States-Flag Vehicle Carriers Under H.R. 3838.

DEAR CONFEREE: The Marine Engineers' Beneficial Association has been at the forefront of efforts to persuade the Japanese automobile manufacturers and the Japanese government to employ a reasonable number of United States-flag vehicle carriers in the important Japan-United States automobile trade. Although the United States is the most important market for Japanese automobiles and even though this trade provides employment for a considerable number of Japanese seamen (approximately 4,000 billets), it has provided no employment for American seamen. This has taken place despite the fact that we permit more than 2.3 million Japanese automobiles to arrive in the U.S. annually—all on Japanese-controlled car carriers.

As I believe you know three Japanese automobile manufacturers have recently agreed to charter four United States-flag vehicle carriers for this trade. This is nothing short of a revolution in Japanese trade practices, but it also signifies that we are able now to offer service every bit as efficient as one of our major foreign competitors. Even though this may be a token gesture by the Japanese, we consider it an extremely important step, and we hope it will be the prelude to the introduction of a considerable number of United States-flag vehicle carriers in this trade.

Each of the four charters was negotiated during 1985, and charter contracts and construction contracts were consummated before June 30, 1986. The companies—Central Gulf Lines of New Orleans; Maritime Overseas Corporation of New York; and Marine Transport Lines of Secaucus, New Jersey—assumed the continued availability of the investment tax credit in working out the charter rates and the financing.

These companies have to honor these contracts the increased costs. In fact, they will lose money because the rates they negotiated are so tight that even with the ITC, they expect just to break even. It would be unfair under these circumstances, I believe, to deny the investment tax credit to these four vessels. Although there is still no provision for protecting the investment tax credit for these vessels in the transition rules in either the Senate or the House versions of H.R. 3838, it is my understanding that Senator Russell Long has agreed, in principle, to sponsor an amendment which would protect the investment tax credit for these vessels.

We have discussed this proposed rule with most of the conferees and they have not expressed any objection to the following transition rule, which I hope you will be able to help shepherd through even at this late date.

PROPOSED AMENDMENT: "AUTOMOBILE CARRIERS"

At page 1518, line 12, add the following as number "(24)" and renumber the ensuing transition rules:

"(24) SPECIAL AUTOMOBILE CARRIER VESSELS.—The amendments made by Section 201 shall not apply to four (4) vehicle carrier vessels which will be constructed by or for United States companies at a total cost of approximately $94,000,000 under transportation contracts that were negotiated during 1985 and were consummated prior to June 30, 1986; the vessels that are the subject of this rule shall be documented under the laws of the United States, comply with United States manning laws, and be used to transport vehicles in the foreign commerce of the United States."

We have here the penetration of a brand new market, a first for American shipping and the kind of aggressive pro-U.S. trade that we all know this country desperately needs. It will provide hundreds of American jobs and more U.S.-flag vessels—at no cost to our government. It is everything that we have all been working so hard for for so many years.

With all best wishes, I remain
Sincerely,

C.E. DEFRIES,
President.

Mr. BUMPERS. Mr. President, I supported the Senate amendments to the House concurrent resolution and I am disturbed by the House action in rejecting these amendments. The Senate has a legitimate role in the constitutional process and I think the amendments we adopted here should

MCorp
A Momentum Company

Richard C. Amacher
Senior Vice President and Manager
Taxation

July 9, 1987

Mr. Bill Wilkins
Committee On Finance
205 Dirksen SOB
Washington, DC 20510

Re: Comments of MCorp on S. 1350

Dear Mr. Wilkins:

On behalf of MCorp, a $20 billion bank holding company located in Dallas, Texas, enclosed are comments on S. 1350, the Technical Corrections Act of 1987 relating to the Tax Reform Act of 1986, introduced by Senators Bentsen and Packwood on June 10, 1987.

As the text of the enclosed comments explains, we feel that an appropriate technical correction for the Act to provide in Sec. 109 is a provision which would allow financially troubled banks to elect to carry bad debt losses back ten years and forward five years, rather than providing that such treatment is mandatory. By so providing, the Tax Reform Act imposes an undue hardship on many financially troubled banks, when it appears that the intent of Congress was to provide relief for banks with large bad debt losses. The hardship stems from the very real possibility that such banks will not be able to solve their financial problems and generate significant amounts of taxable income within the five-year carryover period.

We appreciate the opportunity to comment, and stand willing to provide any further information you may require.

Very truly yours,

R C Amacher

Richard C. Amacher

MCorp is pleased to submit these comments on the Technical Corrections Act of 1987 relating to the Tax Reform Act of 1986. A "relief" provision in the Act actually does more harm than good to many banks which fit the definition of "financially troubled" in Act Sec. 901(c)(3)(B).

Sec. 903(b)(1) of the 1986 Act amends Sec. 172(b)(1) of the Code by adding at the end thereof the following paragraph:

> "(L) Bad Debt Losses of Commercial Banks.--In the case of any bank (as defined in section 585(a)(2)), the portion of the net operating loss for any taxable year beginning after December 31, 1986, and before January 1, 1994, which is

> attributable to the deduction allowed under section 166(a) shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of the loss and a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

This is obviously a relief provision for banks that have not as yet experienced losses sufficient to cause their utilization of the special ten-year carryback provisions mandated by the Tax Reform Act of 1969. These provisions were enacted to become effective in 1976 when severe restrictions on bank loan loss reserve deductions were to take effect. In short, Congress wanted to provide special relief to banks which might find themselves in a position where they have severe loan losses which would not receive current tax benefits due to the then existing three-year carryback.

With the enactment of the 1986 bill, Congress demonstrated a change of heart in that the special 10-year relief provision has been retracted and banks are now subject to the same 3-year carryback and 15-year carryover rules as other taxpayers. The "relief" exception to this rule (cited above) has the potential to do unintended harm to may financially troubled banks.

Many banks have felt the effects of the current energy and real estate depression for the past few years, incurring huge economic losses due to its effect on our customers. In addition, many banks have recently booked huge loan loss reserve additions with respect to loans to less developed countries, since many of these loans are on non-performing status. Inability to collect interest on non-performing loans, and loan charge-offs, which have reached unprecedented levels, together are of such magnitude that the resulting tax losses will in all probability greatly exceed many banks' capacity to carry back into the ten-year period. Indeed, we are concerned that, with only a five-year carryforward period, these banks may never be able to deduct the losses for tax purposes. Taxable income in that short a carryforward period may not be sufficient to absorb the current losses carried forward. In short, the "relief" provision cited above provides no substantial relief; but, rather it is detrimental and we must question realization of any future benefit relating to the tax losses.

The problem is magnified in the situation where banks may be considering affiliation with other companies to ameliorate the aforementioned financial difficulties.

The banking industry and its regulators have been attempting to find a solution to the deteriorating capital positions of many of these banks. For example, the Texas Legislature enacted legislation last year authorizing out-of-state banks to own Texas banks. This was an attempt to provide a private sector solution to banking's financial problems. To allow out-of-state ownership is far superior to alternative solutions which include FDIC assistance or even eventual failure and liquidation by that agency.

In the several months since enactment of that legislation, there have been relatively few mergers announced involving the potential use of private capital to revitalize Texas banks. We believe that one reason for the scarcity of similar transactions is the five-year carryover provision coupled with the limitations on net operating loss and tax credit carryover utilization imposed by Sec. 621 of the Tax Reform Act of 1986 amending Sec. 382 of the Code. Those provisions effectively limit annual utilization of these carryovers to an amount equal to a proxy interest rate times the purchase price of the acquired company. Bank carryovers with less than a five-year life at the merger date face a far greater degree of probability of expiration than would those with the fifteen-year life available to companies in other industries. For example, a bank with $500 million in carryovers which sells out for $1 billion when the proxy interest rate is 6% is limited to maximum post-merger loss utilization of $300 million ($60 million per year for five years). A non-bank company with a fifteen-year carryover would have an increased probability of utilization of the entire $500 million. Since prospective acquirors look to future after-tax earnings of potential acquirees to determine the economic value of entering into a transaction, it is obvious that limiting troubled banks to a five-year carryover is an impediment to finding a solution in the private sector. In our discussions with investment bankers and CPA's, we have come to the conclusion that little, if any consideration is given by potential acquirors to the possibility that these carryovers will ever be utilized.

Section 901(c) of the 1986 Act, which deals with elimination of bank bad debt reserves, calls for the recapture of existing reserves over a four-year period. But Congress, in recognition of the fact that some banks were facing troubled times, provided another "relief" provision in Sec. 901(c)(3)(B) for "financially troubled banks." Such banks are those whose ratio of non-performing loans to shareholders' equity exceed 75%. Such banks are able to delay reserve recapture until that ratio drops below 75%. Although this relief provision was meant to help the affected banks, it is doubtful that many of them will opt to take advantage of the ability to delay recapture, since their current tax is zero with or without recapture, and delaying recapture would only increase net operating loss carryforwards which expire in five years. To the contrary, such banks would opt to recapture all of the reserve as quickly as possible, so as to minimize those carryovers which may expire before utilization.

Given the desire of Congress to provide relief for troubled banks, as evidenced by the provisions cited above, and the lack of relief or even detrimental effect of these same provisions, we suggest the following be incorporated in the Technical Corrections Act.

Make the above cited provision (Act Sec. 903(b)(1)) elective for financially troubled banks. Let those banks which truly need relief select the carryback/carryforward configuration best suited to their own individual situation. Let those banks which receive no benefit from the 10-year carryback "relief" provision nor from the bad debt recapture "relief" provision have the flexibility to achieve relief in this instance. This could be accomplished by adding a sentence to paragraph (L) of Code Sec. 172(b)(1) cited above which states:

> "Use of this provision shall be elective with respect to those banks described in Sec 585 (c)(3)(B)(iii)."

This provision should have no revenue cost in the five-year window period, since the banks already have a five-year carryforward.

This is an opportunity for Congress to provide genuine economic relief for financially troubled banks. We would be grateful for your support, and welcome the opportunity to discuss this further with Congressional staff.

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DIRECT DIAL (213) 739-9175

July 23, 1987

Committee on Finance
United States Senate
205 Dirksen Building
Washington, D.C. 20510

Re: Finance Committee on Taxation and Debt Management Hearing on Technical Corrections Bill (S. 1350)

Gentlemen:

In accordance with Press Release #H-57, on behalf of the California League of Savings Institutions, which represents 215 member organizations, we hereby submit comments with respect to S. 1350, the Technical Corrections Act of 1987.

Modification of 1987 effective tax rate applicable to savings and loan associations.

It is the firm view of the California League that due to legislative oversight in connection with the enactment of the 1986 Tax Reform Act, many savings and loans are currently faced with an anomalous and unreasonable effective tax rate regarding their 1987 tax year.

The legislative history of the 1986 TRA reflects a fundamental, ongoing commitment by both the Administration and Congress to the proposition that as a corollary to the overall increase in the post-1986 corporate taxable base, post-1986 tax rates would not be increased. In this regard the "percentage of taxable income" bad debt reserve method, which is unique to the savings and loan industry, has since its inception in 1951 been treated by Congress, by the regulators and by the accounting profession, as a tax rate concession linked to and conditioned upon an institution's commitment to the primary activity of providing home financing.

The 1986 TRA reduced the general calendar year corporate tax rate from 46% in 1986 to 40% in 1987. The 1986 TRA provided for an additional corporate rate decrease in 1988 and thereafter, but the 1987 "blended" rate is totally consistent with the overriding corporate tax rate precept applied by the 1986 TRA, namely that post-1986 corporate tax rates would thereafter not exceed the 1986 corporate tax rate.

Due to the complexities attendant to the drafting of the 1986 TRA, the reduction provided for the percentage of taxable income bad debt reserve deduction inadvertently violates this principle during 1987. As a consequence, the savings and loan business is in a unique and untenable position, viz: the tax rate applicable to calendar year savings and loans (after taking into account the IRC § 593 percentage of taxable income bad debt deduction) actually increases from 31.28% in 1986 to 36.8 in 1987. After 1987, the tax rate applicable to calendar year associations reverts to 31.28%. Accordingly, while other calendar year corporations are subject to a 13% decrease in their tax rate during 1987, calendar year savings and loans are incurring more than a 17% increase in their tax rate in 1987.

This is clearly neither the intended result nor a fair result. The legislative history establishes a clear pattern of lowering the 1986 tax rate for non-savings and loan corporations by increments in 1987 and thereafter, while retaining the 1986 tax rate for savings and loans. There is no valid policy reason to justify the anomaly of a one-year tax increase applicable to a single industry. Accordingly, there should be a technical amendment to the 1987 percentage of taxable income bad debt reserve method allowance which will assure that the tax rate applicable to savings and loans with regard to their 1987 taxable year shall in no event exceed the pre-1987 and post-1987 rate of 31.28%.

Modification of "at risk" provisions relating to sales of foreclosed real estate ("REO") by savings and loan associations. (Code Section 465).

The Tax Reform Act of 1986 ("1986 TRA") changed the tax consequences of holding real property acquired through the use of non-recourse financing. If a savings and loan provides financing for the sale of its own REO on a non-recourse basis, the purchaser's tax basis in the property is now restricted by the "at risk" rules. If, however, a third party institution regularly engaged in the lending business finances the purchase on a non-recourse basis, the purchaser escapes such tax basis restrictions. It has become apparent, however, that while the new rules have minimal revenue impact, they inhibit normal lending practices and jeopardize the process of an orderly and systematic disposition of foreclosed properties by thrifts. These new rules are particularly prejudicial to savings and loans operating in 10 states (such as California), where state law prohibits lenders from making recourse loans with respect to sale of their own foreclosed properties.

We believe that historically savings and loans have financed more than 80% of the sales of their own REO. Because of the new law, however, potential purchasers will be unwilling to accept seller financing and will seek to arrange financing from third party lending institutions. In many, if not most of such situations, such alternative financing will simply be unavailable because of a lending institution's inherent unwillingness to finance "a competitor's problem," i.e., previously foreclosed and unfamiliar property held by another financial institution. The ramifications of this hindrance are obvious and unnecessary in light of the fact that numerous other restrictions affecting real estate introduced by the 1986 TRA (e.g., the passive loss rule, depreciation stretchouts, capital gains termination) are more than sufficient to satisfy any reasonable perception of potential tax abuse. The most pressing dilemma faced by troubled savings and loans and the Federal Savings and Loan Insurance Corporation is the disposition of REO. Congress should seek to eliminate, rather than impose, obstacles to the disposition of such troubled properties, particularly since the 1986 TRA negated most of the tax benefits formerly associated with the acquisition of rental real estate and thrust such property into a relatively tax disfavored tax position in terms of investment alternatives.

It is the position of the California League that the "commercially reasonable" exception set forth in Code Section 465(b)(6)(D)(ii) and its rationale are similarly applicable to a situation where a savings and loan is financing sales of its own REO to unrelated third parties; that the failure to include such exception in the 1986 Tax Reform Act should properly be viewed as an oversight; and that the Technical Corrections Act of 1987 should provide appropriate relief for REO sold by savings and loans.

Very truly yours,

McKENNA, CONNER & CUNEO

By Martin S. Schwartz

Martin S. Schwartz

M

Mid-America Union

CONFERENCE OF SEVENTH-DAY ADVENTISTS

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June 30, 1987

The Honorable Dan Rostenkowski
Chairman House Ways and Means Committee
Room 2111, Rayburn House Office Building
Washington, DC 20515

Good morning! Sir,

I'm very concerned about the news indicating that the House Ways and Means Committee is looking favorably at a proposal that after June 10, 1987 will reduce the charitable deduction on Charitable Lead Trusts that transfer the funds to the grandchildren. It appears to me that this is a substantial change rather than a technical amendment to the 1986 Act. I appeal to you to keep the charitable deduction in GSTT's "inclusion ratio" formula.

We have many donors that would like to benefit our college and academies with current funds as a part of their estate planning, and the Charitable Lead Trust is one of the finest ways we have of securing present funding for our school needs. And with the heavy financial pressures placed on academic expenses by rising costs, we need all the help we can get in maintaining Christian education in the private sector.

Thank you for giving this your serious attention.

Sincerely yours in Christ's service,

George Woodruff

George Woodruff, Director
Trust Services

GW/mw

MILLER & CHEVALIER

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WRITER'S DIRECT LINE
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July 21, 1987

Committee on Finance
Room SD-205
United States Senate
Washington, D. C. 20510

Dear Sirs:

I am writing to urge consideration of a technical correction that would modify or eliminate the separate foreign tax credit limitations for dividends from each noncontrolled section 902 corporation.

As you know, these separate foreign tax credit limitations were not included in either the House or the Senate bill. Rather, both bills determined the proper limitation by "looking through" dividend payments to the underlying earnings in all cases where the U.S. shareholder had a direct investment in the foreign corporation (i.e. owned at least a 10 percent voting stock interest). This treatment differed from portfolio-type investments in foreign corporations, the dividends from which were treated as passive income. I have been told that these provisions were modified in Conference primarily to simplify the foreign tax credit rules and because of technical concerns that taxpayers might not be able to obtain sufficient information from foreign companies in which they hold less than a majority interest to comply with a look-through rule. The addition of the separate limitations for dividends from each noncontrolled section 902 corporation did not affect the revenue estimate for the foreign tax credit provisions.

Increasingly each year, a large number of U.S. companies undertake international corporate joint venture arrangements. These arrangements are undertaken by U.S. companies to assist in penetrating specific foreign markets (particularly in less developed countries where local ownership is often required), and to take advantage of foreign company technology and manufacturing or marketing expertise. Typically these arrangements are organized by establishing a separate joint venture corporation with the U.S. company owning 50 percent or somewhat less of the total outstanding stock.

The separate limitations for dividends from each uncontrolled section 902 corporation will apply in all of these joint venture arrangements organized in corporate form as long as the U.S. shareholder owns 10 to 50 percent, inclusive, of the foreign corporation. Because a separate limitation applies for each noncontrolled section 902 corporation and there are no "high-tax kick out" provisions, more stringent restrictions are imposed than are faced by U.S. companies that own either more than 50 percent or less than 10 percent of a foreign corporation. Moreover, because some (but not all) taxpayers can take reasonable tax planning steps to avoid the separate limitations for dividends from each section 902 corporation, this both serves as a trap for the unwary and creates arbitrary results. Finally, given other provisions in the foreign tax credit limitation enacted in the 1986 Act, these separate limitations are unnecessary for technical reasons and can be eliminated or modified without undercutting any underlying tax policy principles.

Technical Background

Both the House and Senate versions of the Tax Reform Act of 1986 applied so-called "look-through" rules to dividends and other payments of foreign corporations as long as the U.S. shareholder corporation was eligible to receive deemed paid credits under section 902 with respect to any dividends from that foreign corporation. Thus, the look-through rules generally applied with respect to payments from all foreign affiliates in which U.S. companies owned 10 percent or more of the stock. H.R. 3838, § 601(b) (House bill); H.R. 3838, § 901(b) (Senate bill). This 10 percent threshold reflected the notion that if a U.S. shareholder owned less than a 10 percent interest, it was most properly treated as a portfolio investment with respect to which passive treatment of dividends was appropriate. If, on the other hand, a U.S. shareholder had a ten percent or greater interest in a foreign corporation, it was a direct investment with respect to which active income treatment of dividends was appropriate as long as the corresponding earnings of the foreign corporation were attributable to active income. Thus, the 10 percent dividing line between direct and portfolio investments was the threshold used to trigger application of the look-through rule.

Application of the look-through rule when a U.S. shareholder owned a 50 percent or less interest in a foreign corporation complicated the operation of the rule substantially. Moreover, it required U.S. shareholders to obtain relatively detailed financial information from foreign corporations that they did not control. In Conference the staffs apparently determined that in view of these administrative difficulties, a look-through rule should

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1 The Conference Report and General Explanation also state a rationale that in the case of a non-CFC, "Congress did not believe there is a sufficient identity of interest with U.S. shareholders to treat nonmajority ownership positions as units of a worldwide business . . ." and therefore properly subject to the look-through rules. General Explanation at 868. This rationale is, however, inconsistent with general Code principles that such cases are properly treated as direct investment for which corporate level double taxation is considered inappropriate (under section 902). Moreover, it is inconsistent with the stated rationale for the look-through rule itself, which is to "reduce disparities that might otherwise occur [compared to] . . . income subject to a particular limitation when the taxpayer earns income abroad directly (as through a foreign branch). . . ." General Explanation at 866. Obviously the proper analogy to earning the income directly in the case of a joint venture corporation is to a joint venture partnership, where the equivalent of a look-through rule clearly applies even if the U.S. partner owns a 50 percent or less interest.

generally apply only to corporations that are treated as controlled foreign corporations ("CFCs").[1] Limiting the application of the rule both ensured that taxpayers could obtain the information needed from foreign corporations to apply the look-through rule, and simplified the application of the look-through rule by limiting its application in situations where Subpart F did not also apply. H. Rep. No. 841, 99th Cong., 2d Sess. II-573 and II-583 (1986). Under the Senate and Conference versions of the bill, CFCs were foreign corporations in which U.S. shareholders in the aggregate had more than a 50 percent interest.

Limiting the application of the look-through rule to CFCs raised the issue of how to apply the new foreign tax credit limitations to U.S. shareholders with respect to direct investments in foreign corporations in which they owned at least a 10 percent interest, but not more than a 50 percent interest. The solution adopted was a separate foreign tax credit limitation for each corporation paying such dividends.

Several problems result from this solution. While many well-advised U.S. shareholders can plan around the separate limitations, other shareholders -- for business reasons completely unrelated to tax considerations -- cannot. Those which cannot, where they own 10 to 50 percent of a foreign corporation, are left with a tax treatment under section 904 which is <u>more adverse</u> than if they owned <u>either</u> more than 50 percent or less than 10 percent. The treatment is also more adverse than that had the joint venture been organized as a partnership rather than a foreign corporation. The adverse treatment applies even though the activities and investments of a foreign corporation are substantially the same as that of other joint venture investments which have been able to avoid the separate limitations.

From either a policy or a technical viewpoint, such a solution makes little sense. Moreover, from a technical point of view, it is submitted that with time for more deliberate thought, other less harsh solutions are available to the problems faced in Conference.

<u>Possible Alternative Provisions</u>

<u>Election to be Treated as a CFC.</u> It is generally in the U.S. Government's long-term interest that foreign corporations with substantial U.S. ownership be treated as controlled foreign corporations. Such corporations must comply with extensive U.S. reporting requirements. They are not allowed deferral on various types of "tax haven" income. Further, gain from the sale of stock of such corporations, to the extent of unrepatriated earnings and profits, is treated as a dividend and is not eligible for any capital gains treatment that may from time to time exist.

Notwithstanding these favorable aspects from the U.S. Government viewpoint, taxpayers in most circumstances would elect CFC status if permitted in order to avoid the separate limitations on dividends from each noncontrolled section 902 corporation. The election could be conditioned on the availability of sufficient information to apply and enforce the look-through rules, Subpart F, and other provisions. The election could further be made irrevocable except with the consent of the Commissioner.

Such an election would remove the penalty element inherent in the separate limitations for each noncontrolled section 902 corporation dividends. Particularly if revocable only with consent, taxpayers making the election might well do so to avoid the penalty aspects of the separate limitation without significant regard to the precise long-run impact on future U.S. tax liabilities under Subpart F.

Passive Income Treatment. As an alternative (or in addition) to an election of CFC status, the separate limitations for each noncontrolled section 902 corporate dividends could be eliminated and such amounts treated in all cases as passive income in the same way that dividends from corporations in which the U.S. shareholder owns less than 10 percent are treated. Such treatment would significantly simplify the foreign tax credit rules: only two systems of limitations would exist -- one for all CFC dividends and one for non-CFC dividends. Moreover, any concerns that excess credits from high-taxed dividends of non-CFC corporations could be used to eliminate U.S. tax on other passive income is automatically avoided because the final legislation (unlike the Senate bill and apparently early versions of the Conference agreement) includes the so-called high-tax kick out of section 904(d)(2)(A)(iii)(III). The technical corrections legislation could state clearly that, like with dividends from CFCs, taxes deemed paid by U.S. shareholders with respect to dividends of non-CFCs would be taken into account in determining whether the high-tax kick out applies. Passive income would thus not be sheltered by high-tax dividends. Instead, the dividends would be treated as any other kind of income from non-CFC investments.

Either (or both) of the above approaches would simplify the foreign tax credit separate limitation provisions from a technical point of view and would eliminate the unnecessarily harsh and discriminatory treatment now provided for dividends from companies whose U.S. ownership ranges from 10 to 50 percent. They ought to be given serious consideration in technical corrections.

Sincerely,

Paul W. Oosterhuis

PWO:psb

cc: Ms. Mary McAuliffe
Minority Chief of Staff
Committee on Finance

Statement of the
Mortgage Insurance Companies of America
in connection with the July 22, 1987 Hearings
of the Senate Finance Committee's Subcommittee
on Taxation and Debt Management on S. 1350

The Mortgage Insurance Companies of America ("MICA") is the trade association that represents all firms in the United States that issue policies covering residential mortgage insurance. The industry serves many low-income and moderate-income homebuyers whose only alternative to mortgage insurance would be federal program assistance. Thus, the mortgage insurance industry helps to reduce reliance on the government for housing assistance, which in turn reduces the pressure on the federal deficit.

The industry is proud of its growth record. In the last several years, mortgage insurance companies have paid record volumes of claims to lenders who experienced defaults on their mortgage loans. In 1986, the incurred losses of our member companies were in excess of $1.2 billion. Payments to lenders by the mortgage insurance industry have helped the lenders to replenish needed capital and to reestablish operating momentum. This has been especially important to the many lenders who operate in regions undergoing economic stress. Our insurance role has been validated by our support for institutions insured by the FSLIC and for other entities that channel much needed funds into the housing markets.

By state law mortgage insurance companies must specialize solely in policies related to the financing of 1-4 family housing. The state-approved operating and reserve requirements for firms in our industry have been designed to help private mortgage insurers respond to the changing needs of mortgage originators in different marketplaces. Since 1967 the Internal Revenue Code has recognized the unique nature of our state-regulated business through the special deduction allowed under section 832(e)(2). Code section 832(e) allows an insurance company that writes "mortgage guaranty insurance" to deduct amounts set aside in a reserve for mortgage guaranty insurance losses, but then eliminates any tax benefit that would otherwise arise from such deduction by requiring the company to deposit the amount of taxes saved by utilizing the deduction. The deposits are made through the mechanism of purchasing "tax and loss bonds" of the U.S. Treasury. These bonds are not transferable and pay no interest. The section 832(e) deduction is restored to income when the mortgage guaranty insurance loss reserve falls below the accumulated section 832(e) deductions, or 10 years after the deduction is taken, whichever occurs sooner. When the deduction is restored to income, the bonds are surrendered to pay the tax on such income.

Although the special arrangement under section 832(e) may appear complicated, its purpose is easy to explain. Mortgage insurance companies are required by state law to set aside a reserve equal to a percentage of mortgage insurance premiums. These reserves must be invested in certain types of assets. If the large amounts required to be set aside were not deductible, mortgage insurance companies would have considerable difficulty satisfying their reserve requirements. Assume, for example, that a mortgage insurance company earned premiums of $200. Assume further that the company incurred $80 of deductible expenses and had to establish a nondeductible reserve equal to 50% of premium income, i.e., $100. In 1988, the federal income tax on the company's taxable income of $120 would be $40.80 (34% x $120). After payment of expenses and taxes, the company would have only $79.20 to set aside as a reserve ($200 - $80 - $40.80), even though state law required that a reserve of $100 be established.

Section 832(e) makes it possible for mortgage insurance companies to satisfy their very high reserve requirements without giving these companies the tax benefit of a deduction for such reserves. State regulators accept the convention that tax and loss bonds are an investment, even though they are not transferable, pay no interest, and are redeemed to pay any taxes due when the deduction is reversed. By purchasing tax and loss bonds in lieu of directly paying federal income tax, the mortgage insurance company is in effect able to treat the payment of its federal income tax liability as an investment that is counted towards its statutory reserve requirement. By taking advantage of the special deduction under section 832(e), the company in the foregoing example could have deducted $180 ($80 of expenses and $100 under section 832(e)), would have paid federal income tax of $6.80 (34% x $20), and would have purchased tax and loss bonds of $34 (the tax benefit of the $100 deduction). Its remaining cash ($79.20) plus its tax and loss bonds ($34) would have constituted sufficient assets, in the eyes of state regulators, to satisfy the $100 reserve requirement. The $40.80 of revenue that would have been received by the U.S. Treasury ($6.80 of tax and $34 of tax and loss bond receipts) is exactly the same as the revenue received when no deduction was taken.

As should be clear from the preceding example, mortgage insurance companies derive no actual tax benefit from their deduction under section 832(e), nor does the federal government incur any revenue loss, since the company makes an interest-free loan to the Treasury between the year of the deduction and the year the deduction is reversed.

Section 832(e) was not amended in any way by the 1986 Act. Nor is there any indication in the pertinent committee reports that Congress intended to repeal or modify the special accomodation under section 832(e) between state regulatory requirements and federal revenue needs. Nevertheless, because the new alternative minimum tax ("AMT") was not adequately coordinated with section 832(e), the effect of the AMT may be to curtail substantially the ability of mortgage insurance companies to utilize section 832(e).

Unless the AMT provisions of the 1986 Act are corrected, it will be possible for a mortgage insurance company to become subject to AMT even if it enjoys no tax preference whatsoever. This is demonstrated in Table I of Exhibit A, which uses the same figures as in the preceding examples. Column 1, Table I, shows the taxable income, regular tax liability, and total revenue to the U.S. Treasury in the case of a mortgage insurance company with premium income of $200, expenses of $80, and a reserve of $100. Column 2 shows the net income reported on the books. Because the loss reserve is not deducted on the books, there is a large "book income preference" equal to one-half of the reserve, which produces a large AMT liability.

The existence of an AMT liability in Table I assumes that mortgage insurance companies will not alter their behavior in response to the 1986 Act. In fact, by not purchasing tax and loss bonds, they can reduce their section 832(e) deduction to a point where their AMT liability is reduced to zero. Because the increase in their regular tax liability is exactly offset by their reduced purchases of tax and loss bonds, they can avoid payment of AMT attributable to section 832(e) without any change in their total payments to the Treasury. This is illustrated in Table II, which shows how the company shown in Table I can reduce its AMT to zero by reducing its purchase of tax and loss bonds from $34.00 to $23.80 and its deduction under section 832(e) from $100 to $70. Because the increased regular tax payments that result from the reduced deduction will not be treated as an investment by state regulatory agencies, the company will have to find an alternative method of satisfying its reserve requirement, thereby defeating the policy of section 832(e) without increasing federal revenues by a single cent.

The economic reality of section 832(e) is that the mortgage insurance company gets no deduction and pays the resulting tax, even though its loss reserve additions are formally designated as deductions and its taxes are formally designated as bonds. For the AMT to work properly, it is necessary that the economic reality of section 832(e), rather than its formalisms, be respected. Specifically, no deduction under section 832(e) should be allowed in computing AMTI, and tax and loss bonds should be treated as payments of regular tax. Proposed statutory language to achieve this result is attached hereto as Exhibit B.

Table III of Exhibit A shows the consequences of the proposed technical correction. In calculating the taxpayer's AMTI, the $100 loss reserve is not deducted and the $34 of tax and loss bonds are treated as payment of regular tax. The taxpayer in Table III is able to utilize section 832(e) to the full extent without any reduction in federal revenues. The technical correction would not allow a taxpayer to reduce its AMT liability to the extent it resulted from any reason other than the purchase of tax and loss bonds.

We believe that the foregoing examples and explanation should demonstrate that, unless the proposed technical correction is adopted, the AMT will have the unintended and undesirable effect of curtailing the non-tax benefits of a Code section that confers no tax benefit on the taxpayers that utilize it. MICA and its Tax Reform Task Force would be pleased to work with the Committee and its staff in arriving at an equitable solution to this technical problem.

Joseph J. Komanecki
Chairman
Tax Reform Task Force
Mortgage Insurance Companies
of America

	Table I (1986 Act)			Table II (Reduction of Reserve)			Table III (Technical Correction)		
	(1) Taxable Income	(2) Book Income	(3) AMTI	(4) Taxable Income	(5) Book Income	(6) AMTI	(7) Taxable Income	(8) Book Income	(9) AMTI
Premiums	200	200	200	200	200	200	200	200	200
(Expenses)	(80)	(80)	(80)	(80)	(80)	(80)	(80)	(80)	(80)
(Reserve)	(100)		(100)	(70)		(70)	(100)		
Net Income	20	120	20	50	120	50	20	120	120
Book Preference			50			35			0
AMTI			70			85			120
	x .34			x .34			x .34		
Regular Tax	6.80			17.00			6.80		
			x .2			x .2			x .2
Tentative Tax			14.00			17.00			24.00
(Regular Tax)			(6.80)			(17.00)			(6.80)
(T&L Bonds)									(34.00)
AMT			7.20			0			0
T&L Bonds	34.00			23.80			34.00		
Revenue	40.80			40.80			40.80		

EXHIBIT A

EXHIBIT B

1. Amend section 55(c)(1) by adding two new sentences to the end thereof to read as follows:

> "The regular tax shall include the total amount paid for tax and loss bonds under section 832(e)(2) with respect to the deduction permitted under section 832(e)(1) for the taxable year. The regular tax shall be reduced (but not below zero) by the amount paid in a prior taxable year for tax and loss bonds acquired with respect to a deduction permitted under section 832(e)(1) for such taxable year that is restored to income under section 832(e)(5) in the current taxable year, but regular tax shall only be reduced to the extent that the purchase of such bonds in such prior year increased the regular tax."

2. Amend section 56(c) by adding a new paragraph (4) to the end thereof to read as follows:

> "(4) EFFECT OF SECTION 832(e). --
>
> "(A) DEDUCTION NOT ALLOWED. -- The deduction permitted by section 832(e)(1) shall not be allowed.
>
> "(B) INCLUSION IN GROSS INCOME DISREGARDED. -- The inclusion in gross income required by section 832(e)(5) shall be disregarded."

STATEMENT OF

VESTER T. HUGHES, JR. AND

WILLIAM B. HARMAN, JR.

ON BEHALF OF

MONUMENTAL CORPORATION

BALTIMORE, MARYLAND

CONCERNING S. 1350

THE TECHNICAL CORRECTIONS ACT OF 1987

Statement of Monumental Corporation

Background

Prior to the 1986 Act, a corporation did not recognize gain or loss on a distribution (or deemed distribution) of its assets to shareholders in liquidation. The statutory provisions (including section 338) providing for this result are sometimes referred to as the *General Utilities* rule. This rule was repealed by the Tax Reform Act of 1986 effective, in general, for liquidations, after December 31, 1986.

Monumental Corporation, Baltimore, Maryland, was acquired by Aegon NV on September 3, 1986. Monumental Corporation wishes to make a section 338 election for 1986, but it is unable to do so because of the uncertainty of the effect of such an election. This problem is explained below.

Problem

On April 7, 1986, the Internal Revenue Service, in Announcement 86-47 (Attachment A), indicated that it was studying the tax effects of an insurance company acquisition where a section 338 election was involved (relating to a step-up in basis of assets of the acquired insured company). As of July 1, 1987, no further public announcement had been made with regard to the result of this study.

In a letter dated November 19, 1986 to Messrs. Hughes and Harman (Attachment B), the Chief Counsel of the IRS, William F. Nelson, stated that if this issue -- the effect of section 338 elections on post-April 7 insurance company acquisitions -- "is raised in the course of an examination, I expect it to be resolved on the same basis as other potential tax controversies with respect to which the Service has not adopted a firm interpretation or position."

The result of the IRS statements is that an insurance company electing section 338 after April 6, 1986, and before January 1, 1987, will not know the IRS position as to the tax consequences of such an election. The IRS position had been clear for over 28 years (January 1, 1958 - April 7, 1986); life insurance companies were not taxed at the corporate level if a section 338 election was made because the *General Utilities* doctrine incorporated into section 338 applied to insurance companies, as well as to all other corporate taxpayers.

Discussion

Whatever questions the IRS may have had with respect to an insurance company election under section 338 should be moot since the General Utilities rule was repealed by the 1986 Act.

In view of:

(1) the repeal of the General Utilities doctrine as of January 1, 1987,

(2) the acceptance by the IRS of this doctrine applying to life insurance companies for over 28 years, and

(3) the IRS refusal to state its position for a nine-month period (April - December, 1986),

we believe the IRS position is unfair and discriminatory. It treats similarly situated taxpayers differently, depending solely on whether an acquisition occurred before or after April 7, 1986. The law was not changed by Congress until 1987.

It is impossible to make an intelligent election when the rules are unknown.

Moreover, the Service will not even state whether or not its position will change until after a taxpayer has made an election, filed a tax return and been audited!

Recommendation

Accordingly, we suggest an amendment be made to the transitional rule provisions of the 1986 Act requiring the Service to continue to apply its historical position with respect to section 338 elections by insurance companies for the nine-month period of April 7 - December 31, 1986. This provision could be included in the 1987 Technical Corrections Act, S. 1350.

There is attached a statutory draft to accomplish this result (Attachment C).

We do not believe this proposed amendment involves a revenue loss because it simply requires the IRS to maintain its historical position until January 1, 1987, when the law was changed. We do not believe that the revenue estimtes under the 1986 Act included any revenue attributable to a possible administrative change by the IRS in its 28 year position as to how section 338 applied to insurance companies.

Submitted By,

Vester T. Hughes, Jr.

Vester T. Hughes, Jr.
Hughes & Luce
1000 Dallas Building
Dallas, Texas 75201

William B. Harman, Jr.

William B. Harman, Jr.
Davis & Harman
1455 Pennsylvania Avenue, N.W.
Washington, D. C. 20004

ATTACHMENT A

SEC. 338—STOCK PURCHASES TREATED AS ASSET ACQUISITIONS

• *IRS is considering whether to increase acquired insurance company's taxable income when election is made to treat stock purchase as asset acquisition.* ANNOUNCEMENT 86-47

The Internal Revenue Service is considering the question whether an insurance company's taxable income should be increased by any excess reserves that arise when an election is made under Section 338 to treat the purchase of its stock as an asset acquisition. That situation can arise, for instance, if the parties allocate some of the value of the acquired insurance company to an asset (other than goodwill) identified as "insurance contracts in force." Such allocation reflects the fact that the amount of the reserves exceeds the amount that an unrelated party would require as consideration for agreeing to assume the net liabilities underlying the insurance contracts of the acquired company.

Should the IRS decide that income is properly increased in this situation, that decision will not affect insurance company acquisitions occurring before April 7, 1986. Also, the IRS will not increase the income of an acquired insurance company in analogous situations in which former Section 334(b)(2) applies to the liquidation of an acquired insurance company.

Full Text: The Internal Revenue Service is considering whether the rules of subchapter L of the Internal Revenue Code (and, in the case of life insurance companies, section 1.817-4(d) of the Income Tax Regulations) and/or the "tax benefit" rule require the taxation of income from the release of certain reserves when an election is made under section 338 of the Code to treat the purchase of stock of an insurance company as an asset acquisition. For instance, if the parties to an insurance company acquisition allocate some of the value of the acquired company to an asset (other than goodwill) identified as, for example, "insurance contracts in force," then that allocation reflects the fact that the amount of the reserves of the acquired company exceeds the amount that an unrelated party would require as consideration for agreeing to assume the net liabilities underlying the insurance contracts of the acquired company. The Service is considering whether acquired company's taxable income is properly increased by the amount of that excess.

Should the Service decide that income is properly increased in this situation, then as an exercise of the Commissioner's authority under section 7805(b) of the Code, the Service will not so increase the income of an acquired insurance company, provided that the acquisition date, as defined in section 338(h)(2) of the Code, occurred before April 7, 1986, the date of publication of this announcement. In addition, under the authority of section 7805(b), the Service will not so increase the income of an acquired insurance company in analogous situations in which former section 334(b)(2) applies to the liquidation of an acquired insurance company.

CHIEF COUNSEL

ATTACHMENT B

Internal Revenue Service
Washington, DC 20224

NOV 1 0 1986

Vester T. Hughes
Hughes & Luce
1000 Dallas Building
Dallas, Texas 75201

William B. Harman, Jr.
Davis & Harman
1445 Pennsylvania Ave., N.W.
Suite 1200
Washington, D.C. 20004

Dear Vester & Bill,

I am writing to follow up on our meeting of last month regarding the question whether the seller of a life insurance business should be required to recognize income on the release from liabilities under the insurance contracts under section 1.817-4 of the Income Tax Regulations.

As you know, Treasury and the Service previously reached a decision that, whatever the correct answer may be as a technical matter, section 7805(b) relief would be granted only for transactions occurring before April 7, 1986. After a great deal of thought and consideration, I have decided not to change that decision. If this issue is raised in the course of an examination, I expect it to be resolved on the same basis as other potential tax controversies with respect to which the Service has not adopted a firm interpretation or position.

Sincerely,

WILLIAM F. NELSON

Department of the Treasury

ATTACHMENT C

Statutory Draft

The following amendment will require the IRS to continue to apply its pre-April 7, 1986, rules to insurance company acquisitions occurring after April 6, 1986 and before January 1, 1987:

SEC.______. AMENDMENT RELATED TO SECTION 633 OF THE 1986 ACT.

Subsection (e) of section 633 of the Tax Reform Act of 1986 (relating to other transitional rules) is amended by adding at the end thereof the following new paragraph:

"(9) (A) Any transaction described in section 338 of the Internal Revenue Code of 1986 for which the acquisition date (as defined in subsection (h)(2) of section 338) occurs after April 6, 1986 and before January 1, 1987 shall be governed by the rules referred to in IRS Announcement 86-47 as applied prior to the date of such publication.

(B) In the case of any transaction described in subparagraph (A), the time for making an election under paragraph (g) of such section 338 shall not expire before the 60th day after the date of enactment of this Act. A section 338 election made in accordance with the preceding sentence shall revoke and supercede a protective carryover basis election under section 1.338-4T(f)(6) of the Income Tax Regulations that previously was made with respect to a transaction described in subparagraph (A)."

Summary

Statement of
Vester T. Hughes, Jr. and William B. Harman, Jr.
On Behalf of
Monumental Corporation, Baltimore, Maryland

The Tax Reform Act of 1986 repealed the *General Utilities* rule effective, in general, for liquidations after December 31, 1986. This repeal included section 338.

On April 7, 1986, the IRS announced it was studying the tax effects of an insurance company acquisition where a section 338 election was involved (IRS Announcement 86-47). This announcement came after the IRS had not questioned the applicability of section 338 to insurance company acquisitions for over 28 years. The IRS will not state whether it will either change its position or continue to follow its historical position until a taxpayer has made an election, filed a tax return and been audited. Thus, no insurance company can make an intelligent election because of the uncertainty of the IRS position.

In effect, the IRS is attempting to repeal section 338 only for life insurance companies (without any authority) as of April 7, 1986, whereas Congress repealed section 338 for all corporations (including life insurance companies) as of January 1, 1987. This IRS position is unfair and discriminatory.

Consistent with its repeal of section 338, Congress should rquire the IRS to continue to apply its historical position with respect to section 338 elections by insurance companies for the nine month period of April 7 - December 31, 1986.

We do not believe this proposal would involve a revenue loss since it simply requires the IRS to follow existing section 338 until the effective date of its repeal by Congress.

THE MOUNT SINAI MEDICAL CENTER
ONE GUSTAVE L. LEVY PLACE • NEW YORK, N.Y. 10029

Mount Sinai School of Medicine • The Mount Sinai Hospital

Office of Development (212) 650-6976

June 30th, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

In the strongest terms possible, I wish to protest the proposed loss of the charitable deduction as an offset against the generation-skipping tax on Charitable Lead Trusts.

Such trusts are not so much for the advantage of the rich as they are for the benefit of the poor. The true beneficiaries of Charitable Lead Trusts are the recipients of services who would otherwise suffer from want. Lead trust funding is crucial to Mount Sinai Medical Center and its programs in the Spanish Harlem Community. Additionally, lead funding provides the nation with world class research and superior medical care here at Mount Sinai.

Please pass on to the appropriate Senators our dismay over the proposed changes. Simply stated, the loss of this deduction will be a terrible blow to lead trust funding.

Sincerely,

Blair Hearth
Director of Planned Giving
Mount Sinai Medical Center

BH:mib
cc: Ritchie Geisel

August 26, 1987

Laura Wilcox, Hearing Clerk
Room SD08 205
Washington, D.C. 20510

Subject: Technical Corrections Bill - S 1350, Tax Reform Act of 1986

Dear Ms. Wilcox,

Please enter the following letter onto the record to become an official part of the comments on Bill No S 1350:

I am writing to protest a provision in the TRA-86 that will have grave repercussions on the state of the arts in this country. You have an opportunity, in your consideration of the Technical Corrections Bill S-1350, to correct this situation, which I am sure arises from a misunderstanding.

This bill treats the writing of a book or screenplay in the same fashion, for tax purposes, as the production of nuts and bolts and garment hooks The expenses of writing a book are treated as one would treat the expenses involved in producing a home computer They are not the same

If I, as a beginning writer, get an idea for a book, I have to do research. I may have to make telephone calls, travel, buy books. Having done all this, I may or may not write the book If I write it, I may or may not sell it. Even if I don't write it, the experience of writing it may help me write a later book

I may end up writing an entirely different book, years later, which had its genesis in research done years ago. And if I sell it, I have no way of knowing whether I will receive royalties on it, and if so, for how long

Writing is not the same kind of process that manufacturing is. We write whether we sell anything or not We have no idea what the life of our works might be Writing is not a mechanical process We cannot distinguish certain expenses and assign them exclusively to certain projects, because a writer is not just a producer of books, stories, poems. A writer writes Writing is the profession, not producing a given book Everything is "grist for the mill." If we sell, and if we sell enough to make a living at it, we are exceptionally lucky Most writers don't No writer can predict his income from one year to the next No writer can predict the income from a given project It cannot be done

To ask us to capitalize our expenses as TRA-86 does is to demonstrate a lack of understanding of creative work It will also force many people, like me, out of writing as a profession. Why should I spend my life trying to write good books when I will starve in the process, trying to determine how many paper clips I used on which manuscript, and whether the stamps on a letter to an editor should be assigned to a book in process, or one that may or may not be written? And if I and people like me are forced out of the profession, what will your children read?

I can hardly hope for the enlightenment that Irish law shows to income earned from writing, but surely, surely the United States can do better than this. I appeal to you to strike this clause from the Tax Reform Act. It is a matter of the utmost importance to the future of this country.

Sincerely,

A.A. McConnell

Ashley McConnell
6316 Driscoll NE
Albuquerque, NM 87109

REMARKS OF ROBERT V. VAN FOSSAN

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

OF THE MUTUAL BENEFIT LIFE INSURANCE COMPANY

EXECUTIVE SUMMARY

Income from sales in the intensely competitive pension marketplace of the early 1980's required investments which would support long term guarantees of the high interest rates of those years. Deep discount bonds were the best available investments for this purpose, since they protected the Company against losses from redemptions if interest rates returned to lower rates. The favorable capital gains treatment further enabled Mutual Benefit to guarantee even higher interest rates to pension contract holders. The above facts resulted in favorable grandfathering in the Deficit Reduction Act of 1984.

The issue of the taxability of gain realized on these bonds was reconsidered in the 1986 Act. Ultimately, the House allocated $119 million to a transition rule to solve the problem. Throughout these discussions, Mutual Benefit argued for a generic rule which would have treated all companies the same. However, at the time of enactment, available fragmentary data suggested that the 15 companies most concerned with this issue would use up the entire $119 million. Current, more accurate, information now shows that a generic rule would require only $146 million to provide for the entire industry at 28%. If Congress can not allocate the additional money required for a 28% rate, a 29.1% generic capital gains rate would accommodate the entire life insurance industry within the original $119 million guideline.

While an industry-wide generic rule was originally and still is most preferable, it is important that the rate that was originally applied to the 15 named life insurance companies not be raised substantially. The named insurance companies not only relied on the grandfather clause in the Deficit Reduction Act of 1984 when we made our initial investment, but also relied on the transition rule, as enacted, by not selling bonds in 1986 that we otherwise would have sold. What is needed is a way to make the capital gains transition rule applicable to the entire life insurance industry without harming those of us in the industry that previously were granted relief.

We strongly urge you to change the 15 company rule to a rule applicable to all insurance companies. If in your best judgment the cost of generic treatment at 28% is still prohibitive, please redistribute to all insurance companies the $119 million of relief that was committed in the 1986 Act. A 29.1% rate will accomplish this.

Mr. Chairman: I am Robert V. Van Fossan, Chairman and Chief Executive Officer of The Mutual Benefit Life Insurance Company of Newark, New Jersey. I appreciate this opportunity to submit my comments regarding the increase in the capital gains tax rate on pre-1984 Act Market Discount Bonds from 28% to 31.6% under the proposed Technical Corrections Act of 1987. I recognize that this transition rule was not crafted by the Senate Finance Committee, but was initiated in the House. I felt it important, nonetheless, to bring to your attention our position on this matter which throughout has been for the adoption of a rule which treats all companies the same.

Mutual Benefit Life is a medium sized mutual life insurance company which was a major participant in the issuance of Guaranteed Interest Contracts in the early 1980's. These contractual commitments were made by Mutual Benefit to the holders of large contracts which support the country's private pension system. These contracts were negotiated in an intensely competitive marketplace resulting in narrow profit margins. To support the long term guarantees of the high interest rates then in effect (14% to 16%), it was necessary to seek out investments which would not be redeemed as interest rates returned to normal. Such redemptions would have created substantial losses to the Company. The best available investments with such safety were deep discount bonds. The Company, in fact, passed on the capital gains differential to the pension plan buyers in the form of higher interest rate guarantees.

At the time of the enactment of the Deficit Reduction Act of 1984, these factors were carefully considered. A decision was reached in that Act to tax gains on bonds issued prior to July 19, 1984 at 28%. Mutual Benefit sought no more than that, and has relied upon this law.

The issue of the taxability of gain realized on these bonds was reconsidered in the 1986 Act. Ultimately, the House allocated $119 million to a transition rule to solve the problem. Throughout these discussions, Mutual Benefit argued for a generic rule which would have treated all companies the same. However, at the time of enactment, available fragmentary data suggested that the 15 companies most concerned with this issue would use up the entire $119 million. Current, more accurate, information now shows that a generic rule would require $146 million to provide for the entire industry at 28%. If the Congress feels it should not allocate the additional money required for a 28% rate, a 29.1% generic capital gains rate would accommodate the entire life insurance industry within the original $119 million guideline.

The Mutual Benefit Life Insurance Company is currently holding bonds purchased at market discount in reliance upon the provisions of the 1984 and 1986 Tax Acts. The differential between the corporate capital gains rate under the 15 company transition rule and the rate in the Technical Corrections Act of 1987 will cost Mutual Benefit approximately $6 million in additional taxes. Such an increase in our taxes makes this provision more than a mere technical correction to us.

While an industry-wide generic rule was originally and still is most preferable, it is important that the rate that was originally applied to the 15 named life insurance companies not be raised substantially. The named insurance companies not only relied on the grandfather clause in the Deficit Reduction Act of 1984 when we made our initial investment, but also relied on the transition rule, as enacted, by not selling bonds in 1986 that we otherwise would have sold. What is needed is a way to make the capital gains transition rule applicable to the entire life insurance industry without harming those of us in the industry that previously were granted relief.

Mr. Chairman, I strongly urge you to change the 15 company rule to a rule applicable to all insurance companies. If in your best judgment the cost of generic treatment at 28% is still prohibitive, please redistribute to all insurance companies the $119 million of relief that was committed in the 1986 Act. A 29.1% rate will accomplish this.

NATIONAL ASSOCIATION OF BOND LAWYERS

NABL

POST OFFICE BOX 397
HINSDALE, ILLINOIS 60522
312/920-0160

COMMENTS REGARDING TECHNICAL CORRECTIONS ACT OF 1987

Set forth below are the comments of the National Association of Bond Lawyers regarding the tax-exempt bond provisions contained in the Technical Corrections Act of 1987, introduced on June 10, 1987. These comments are divided into three categories: (1) comments regarding the need for clarification of certain technical corrections; (2) comments regarding substantive change caused by certain technical corrections; and (3) comments regarding other required technical corrections.

As used herein, the term "Bill" means the Technical Corrections Act of 1987, introduced as S.1350 in the United States Senate and H.R. 2636 in the United States House of Representatives. The term "Act" means the Tax Reform Act of 1986. The term "1986 Code" means the Internal Revenue Code of 1986 as enacted by the Act. The term "1954 Code" means the Internal Revenue Code of 1954. The term "Explanation" means the "Description of the Technical Corrections Act of 1987," released by the staff of the Joint Committee on Taxation on June 15, 1987. The term "Blue Book" means the "General Explanation of the Tax Reform Act of 1986" released by the Staff of the Joint Committee on Taxation on May 8, 1987.

TECHNICAL CORRECTIONS REQUIRING FURTHER CLARIFICATION

Small Issuer Exemption from Rebate: Entities Formed for Application of Exemption. Section 113(a)(17)(A)(iii) of the Bill adds clause (ii)(III) to section 148(f)(4)(C) of the 1986 Code indicating that, in determining the application of the small issuer exemption from rebate, there must be included "an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of" the small issuer exemption from rebate. Clause (ii)(III) should be deleted from the amendment made by section 113(a)(17)(A)(iii) of the Bill.

The inclusion of clause (ii)(III) implies that citizens will form local government units with general taxing powers solely for the purpose of application of the $5,000,000 exemption from rebate. This is highly unlikely and, even if true, is not possible of determination. Formation documentation will not indicate purposes for formation beyond governmental purposes, bond counsel will not be capable of applying the provision and the Internal Revenue Service will not be capable of enforcing the provision.

Small Issuer Exemption from Rebate: Certain Current Refunding Bonds. Section 113(a)(17)(A)(iii) of the Bill adds clause (iii) to section 148(f)(4)(C) of the 1986 Code indicating that, in determining the application of the small issuer exemption from rebate, there shall not be taken into account "any bond issued to refund (other than advance refund) any bond to the extent the amount of the refunding bond does not exceed the outstanding amount of the refunded bond." (Emphasis added.) Application of the underlined phrase is unclear. If a refunding bond is issued in the amount of $4,000,000 to refund the $3,000,000 outstanding amount of a prior bond, does clause (iii) mean that the entire $4,000,000 refunding bond must be counted in determining the application of the exemption because the principal amount of the refunding bond exceeds the outstanding principal amount of the refunded bond? Or does clause (iii) mean that only $1,000,000 of the refunding bond must be counted in determining the application of the exemption? If the former meaning is intended, the word "if" should be substituted for the underlined phrase.

Change in Use Provisions Applied to Small Issue Private Activity Bonds. Section 113(a)(23)(A) of the Bill amends section 150(b)(4)(B) of the 1986 Code by inserting the phrase "or a qualified small issue bond" indicating that the change in use provisions apply to terminate interest deductibility for small issue bonds in the case of facilities financed with such bonds "if such facility is not used for a purpose for which a tax-exempt bond could be issued on the date of such issue" (Section 150(b)(4)(A) of the 1986 Code). The Explanation indicates, as one example of a change in use for a small issue bond, a post-issuance capital expenditure which results in violation of the $10,000,000 limitation applicable to small issue private activity bonds. It is strenuously objected that such a capital expenditure is not a change in "use"; rather a change in use would result, for example, from use for a commercial purpose of a facility financed with bonds exempt by reason of an original use for a manufacturing purpose. If it is intended that violation of the $10,000,000 result in a loss of the interest deduction, Section 113(a)(23)(A) of the Bill should specifically so indicate.

Improper Code Reference. Section 113(c)(12)(A) of the Bill relates to an amendment to subparagraph (N) of section 103(b)(6) of the "1986 Code." The reference to the Code should be changed to the "1954 Code," as was done in section 113(c)(12)(B) of the Bill.

Extension of Origination Period for Current Refundings of Qualified Mortgage Bonds. In discussion of the extension of the 1954 Code sunset date for issuance of qualified mortgage bonds and bonds issued to refund qualified mortgage bonds, the Explanation states on page 244, ". . . refundings permitted under this expansion of the transitional exception may not involve an extension of the period for providing financing to homebuyers." A similar statement was contained in the Conference Report, published September 18, 1986, on page II-716 and in the Blue Book on page 1230. The statement is not supported by specific statutory language in either the Act, the 1986 Code or the 1954 Code.

Congress, in both the 1986 Code and in the 1954 Code, placed certain limitations upon the type and amount of qualified mortgage bonds and mortgages acquired with qualified mortgage bonds, as well as certain limitations upon arbitrage earnings. In none of these limitations is there a limitation upon the period during which mortgages can be originated. It is clearly unacceptable for the Explanation to indicate a limitation where there is none.

SUBSTANTIVE CHANGES MADE BY BILL

Measure of Issuance Costs Limitation and of Safe Harbor Exception from Rebate. Section 113(a)(13) of the Bill amends section 147(g) of the 1986 Code to apply the limitation on issuance costs against the "proceeds" of the bonds, rather than against the face amount of the bonds as is now set forth in section 147(g) of the 1986 Code. Similarly, section 113(a)(16) of the Bill amends section 148(f)(4)(B)(iii)(I) of the 1986 Code to apply the measure of the cumulative cash flow deficit against the "proceeds" of the bonds, rather than against the face amount of the bonds as is now set forth in section 148(f)(4)(B)(iii)(I) of the 1986 Code. Although not set forth in the 1986 Code, staff has indicated that the term "proceeds" means an amount equal to the reoffering price of the bonds to the public. Such changes are substantive changes not appropriately made by a technical corrections act.

Many issuers sell their bonds at public sale after bidding. Under this arrangement, the issuer will cause the official statement to be prepared and printed, will cause notice of bids to be published two to three weeks prior to the bid opening, will receive bids and award the bonds to the winning bidder at the bid opening and will issue the bonds one to three weeks following the award of the bid. Under this procedure, the principal amount of the bonds must be determined prior to the time that the official statement is printed and the bids on the sale of the bonds are received, yet the amount of "proceeds" of the bonds is not known until after the winning bidder at the public sale resells the bonds to the public.

If, for example, an issuer determines that the principal amount of tax and revenue anticipation notes to be sold at public sale will be $10,000,000, based upon a projected safe harbor cumulative cash flow deficit of $9,000,000 and if, following public sale of the bonds, the winning bidder indicates that the notes were resold to the public at an original issue discount of one percent, the "proceeds" of the notes would be $9,900,000 and on the date of delivery of the notes, the issuer would know that if its projected cumulative cash flow deficit becomes the actual cash flow deficit, the "safe harbor" for rebate purposes will not be achieved because the projected deficit will exceed 90 percent of the reoffering price of the notes. The modifications suggested by the Bill have a substantive effect upon issuer procedures for bond sale, may force the negotiated sale of bonds or the imposition of artificial restraints upon the reoffering price of the Notes. Such substantive provisions are improper points for inclusion in a technical corrections bill.

Application of Rebate Rules to Refunding Bonds. Section 113(a)(17)(A)(iii) of the Bill adds new clause (iv) to section 148(f)(4)(C) of the 1986 Code indicating that, unless certain stringent restriants are satisfied, the $5,000,000 small issuer exemption from rebate requirements does not apply to refunding bonds. Included among these restraints is a requirement that the refunded bonds must have satisfied the $5,000,000 exemption when issued. Thus, if the refunded bond either satisfied the rebate requirement or was exempt from the rebate requirement due to the expenditure exemption or for other statutory reason, the refunding bond would be automatically ineligible for the small issuer exemption. There is no indication in the Act that Congress did not intend for the small issuer exemption to apply to refunding bonds (as well as new money bonds) without limitation, and there is no clear reason for a distinction between bonds which refund prior bonds which complied with rebate requirements and bonds which refund prior bonds which were exempt from rebate requirements, and bonds which are issued for provision of construction funds, acquisition funds, or working capital funds. The distinction which Congress made in the Tax Reform Act of 1986 and which should be maintained without erosion by the Technical Corrections Act of 1987 is a distinction between issuers rather than a distinction between purposes of bond issuance. The exclusion of refunding bonds from the exemption. Proposed clause (iv) of section 148(f)(4)(C) is substantive in effect and highly inappropriate for a technical corrections bill. Proposed clause (iv) should be withdrawn.

Designation of Refunding Bonds. Section 109(b)(5) of the Bill provides reformulated rules to determine whether refunding bonds may qualify as qualified tax-exempt obligations ("QTEO's") for certain bank deductibility provisions and to indicate how refunding bonds are to be taken into account in determining whether other bonds qualify as QTEO's. This comment offers our understanding of the legislative language that the Bill would add to the 1986 Code as section 265(b)(3)(F) and (G) and offers our reasons for concluding that the Explanation fundamentally misrepresents the plain meaning of that language.

Section 265(b)(3)(F) provides a general rule that in determining the status of a non-refunding bonds, a refunding bond will not be taken into account for purposes of the $10 million limit of section 265(b)(3)(C) provided that (1) the refunding is not an advance refunding and (2) the amount of the refunding issue does not exceed the outstanding amount of the refunded issue. Thus an issuer may issue up to $10 million of construction (non-refunding) bonds in a year and designate them as QTEO's notwithstanding the fact that the issuer issues additional amounts of refunding bonds during the year, provided the refunding bonds meet the standards of section 265(b)(3)(F).

Section 265(b)(3)(G)(i) denies QTEO status to any bond that is part of an issue that includes any refunding bonds and exceeds $10,000,000 in aggregate face amount. This rule means that an issuer could not issue a multi-purpose issue of $15 million of which $7 million was refunding bonds and $8 million of construction bonds as QTEO's on the ground that section 265(b)(3)(F) made the $7 million of refunding bonds irrelevant.

Section 265(b)(3)(G)(ii) allows refunding issues that meet the test of section 265(b)(3)(G)(i) to achieve QTEO status through either a regular designation or a "deemed" designation. Under the regular designation route, the refunding issue must meet the general standards applicable to non-refunding issues, such as the limitation of section 265(b)(3)(A) that the total of the designated issue plus all other bonds issued (or anticipated to be issued) during the same calendar year cannot exceed $10,000,000. Under the deemed designation route, the issue must pass muster under a different set of standards: specifically, the prior bonds must themselves have been QTEO's, and the refunding must be a "non-advance" refunding which does not exceed the outstanding amount of the prior bonds and which complies with specified maturity limits. The deemed designation route does not, however, require the issue to take into account other bonds issued during the calendar year. Thus an issuer using the deemed designation provisions can preserve the QTEO status of a financing through one or more refundings even though there are other financings during the year of the refundings such that the refunding bonds could not qualify outside the deemed designation provisions.

The Explanation states that the deemed designation provisions are the only route by which a refunding issue can achieve QTEO status. In other words, the Explanation takes the position that a refunding issue cannot be a QTEO issue unless the prior issue "was designated, qualified for, and was taken into account under the $10 million limitation when issued." (Page 76.) This comment by the Explanation is not supported by the statutory language of the Bill, which as noted above permits refunding bonds to qualify either by actual designation or by deemed designation. Further, the rule proposed by the comment is not justified by any sensible policy. It is inappropriate to deny an issuer which issued bonds prior to the effective date of the 1986 legislation the opportunity to refund them with QTEO's, provided the refunding bonds meet the tests set forth for refunding bonds as described herein.

REQUIRED ADDITIONAL TECHNICAL CORRECTIONS

Inclusion of "On Behalf Of" Issuers in Small Issuer Rebate Exception. The small issuer exception from rebate requirements contained in section 148(f)(4)(C)(i) of the 1986 Code relates to governmental units with general taxing powers. Congressional staff has indicated that the exception applies to entities which issue on behalf of governmental units with general taxing powers. It is suggested that subclause (I) (as redesignated by section 113(a)(17)(A)(ii) of the Bill) of section 148(f)(4)(C)(i) of the 1986 Code be amended to read as follows (new language is indicated by underlining):

> (I) the issue is issued by or on behalf of a governmental unit with general taxing powers.

It is also noted that there appears no clear legislative purpose to limiting the small issuer exemption to governmental units with general taxing powers. The intent of the exception should be to limit its application to governmental bonds. We suggest, therefore, that consideration be given to the entire elimination of of subparagraph (I).

Change in Use Rules Applied to Transitioned Refundings of Residential Rental Bonds. Section 1313(a) of the Act permits current refundings of certain bonds, including residential rental bonds originally issued as tax-exempt under section 103(b)(4)(A) of the 1954 Code. Subparagraph (E) of section 1313(a)(3) of the Act indicates that the change in use provisions contained in section 150(b) of the 1986 Code apply to such transitioned refunding bonds. Paragraph (2) of section 150(b) of the 1986 Code relates to change in use of facilities financed with bonds issued as tax-exempt under section 142(a)(7) of the 1986 Code and does not refer to facilities financed as tax-exempt under section 103(b)(4)(A) of the 1954 Code. Since it was not the purpose of the transition rule for refundings of residential rental projects to impose the new low income restrictions applicable to bonds issued under section 142(a)(7) of the 1986 Code, subparagraph (E) of section 1313(a)(3) of the Act requires modification to indicate its inapplicability to bonds issued to refund prior bonds issued as tax-exempt under section 103(b)(4)(A) of the 1954 Code. It is suggested that section 1313(a)(3)(E) of the Act be amended by the Bill to read as follows (new language is indicated by underlining):

> (E) Except in the case of bonds issued for facilities qualifying under section 103(b)(4)(A) of the 1954 Code, the provisions of section 150(b) of the 1986 Code (relating to change in use).

Rebate as Applied to Tax and Revenue Anticipation Noes. Section 148(f)(4)(B)(iii) of the 1986 Code relates to an exemption from rebate for tax and revenue anticipation notes which satisfy a "safeharbor" in terms of cumulative cash flow deficits. Footnote 173 of the Blue Book indicates that it is expected that the Treasury Department will treat deficits as occuring only if no amounts other than bond proceeds are available to pay expenses for that which the proceeds are used. In determining available amounts, amounts in special purpose accounts or otherwise earmarked are available if the governmental unit either (1) established the restrictions on the use of the other funds or (2) has the power to alter the use of the other funds. Footnote 173 indicates a significant expansion of the definition of "available revenues" under existing Treasury regulations.

It is contended that Congress did not intend that present Treasury regulations of "available revenues" be modified when Congress enacted the safe harbor exception to rebate. The Bill should modify Section 148(f)(4)(B)(iii) to include a definition of "available revenues" which is based upon the definition of such term which is included in present Treasury regulations.

Security for Qualified Redevelopment Bonds. Subparagraph (B) of section 144(c)(2) of the 1986 Code relating to the security for qualified redevelopment bonds is unclear. It has been variously stated that existing clause (i) was designed to permit general obligation bonds, real property tax increment bonds, sales tax increment bonds and bonds combining one or more of such sources of security. It has also been indicated that no discrimination between sources of security was intended by the reference in existing clause (i) to "primarily secured by" as contrasted with the reference in clause (ii) to "reserved exclusively for". It has also been indicated that the reference to "reserve exclusively for" was not intended to eliminate state statutory requirements for use of tax increment for, for example, low or moderate income, or to eliminate past and future contracts and other arrangements whereby a portion of tax increment was provided to governmental units not engaged in redevelopment or renewal, for example, to school districts to be used for school purposes, as opposed to its use for bond debt service. The Blue Book indicates that payment of the bonds is not to be "derived from" payments such that the bonds would have been rendered as industrial development bonds under prior law, but there is no indication in the Act that this is true. A clarification which conformed to the Blue Book would be a substantive, rather than a technical change. It is suggested that subparagraph (B) of section 144(c)(2) of the 1986 Code be amended to read as follows:

> (B) the payment of the principal and interest on such issue is primarily secured by taxes of general applicability, or an increment thereof, imposed by a general purpose governmental unit.

Application of Maturity Limit to Qualified 501(c)(3) Bonds for Working Capital. Qualified 501(c)(3) bonds may be issued for the financing of purposes other than facilities. For example, qualified 501(c)(3) bonds may be issued for financing of working capital or refunding of prior debt. In such event the maturity limitation is inapplicable, by its terms. It is suggested that the original intent of Congress be clarified by amending section 147(h)(2) of the 1986 Code by adding a new sentence at the end thereat to read as follows:

> 'Subsection (b) shall apply to qualified 501(c)(3) bonds only with respect to facilities financed with such bonds.'

Application of Expenditure Exception to Rebate Requirement. Under present law, rebate requirements do not apply if gross proceeds of an issue are expended for the governmental purpose of the issue within 6 months of issuance. Most issues, however, provide for the funding of a reasonably required reserve fund in addition to funding for the primary governmental purpose of the issue. Reserve funds are retained to assure that a source of payment of the issue is available in the event of a temporary insufficiency of other sources of payment of debt service. It is suggested that the expenditure exception to the rebate requirement be amended to provide that a reserve fund need not be expended in order for the 6 months expenditure exception to apply.

It is also suggested that the expenditure exception be amended to to provide that the use of proceeds of an issue for redemption of the issue be treated as an expenditure for the governmental purpose of the issue on the date upon which such redemption is made.

In certain cases, the issuer may fully intend on the date of bond issuance to expend the proceeds of the bonds within six months thereof, but for reasons beyond the control of the issuer or for inadvertence, the issuer is unable to expend such proceeds. The suggested amendment would enable an issuer to cure the problem and thus to avoid rebate procedures by using the amounts which were not expended for redemption of the bonds. The Federal Government will thereby derive more revenue from the elimination of outstanding tax-exempt bonds than it would from the rebate of "excess" investment earnings.

Change in Use for Single Family Housing Bonds. Footnote 196 on page 1221 of the Blue Book indicates that, with respect to the change in use provisions contained in section 150(b)(1) of the 1986 Code for qualified mortgage bonds, Congress intended that the disallowance of interest deductions for bond-financed housing cease prospectively if the residence again qualifies as the mortgagor's principal residence. The footnote indicates, "A technical amendment may be necessary for the statute to reflect this intent." Such technical amendment should be made by the Bill.

Definition of "Proceeds". The term "proceeds" is used in a number of the provisions contained in sections 141 through 150 of the 1986 Code. Staff has indicated that the term "proceeds" means an amount equal to the reoffering price of the bonds to the public, that is, an amount equal to the price at which a substantial amount of the bonds of each maturity were sold to the public. Generally, this amount is equal to the face amount of the bonds, plus accrued interest on the bonds, plus original issue premium, less original issue discount. The term should be defined in the Bill.

Retroactive Designation of Bonds as Qualified Bonds for Purposes of Bank Deductibility Provisions. Section 109(b)(3) of the Bill provides that issuers may retroactively designate their bonds as bank qualified under the $10 million exception if certain conditions are met. For bonds issued after August 7, 1986 and before January 1, 1987, the issuer has until January 1, 1988 to make the designation. However, for bonds issued between January 1, 1986 and August 7, 1986, an additional requirement is added that the issue must have made a designation a' the time of issue that it intended to qualify under section 802(e)(3) of H.R. 3838.

There is no persuasive reason for this additional requirement for bonds issued on or before August 7, 1986. Many small issuers did not make designations during such time period simply because the House Bill was pending and not yet law. Other small issuers thought they were protected by the March 14, 1986 Joint Statement and essentially ignored H.R. 3838. These issuers are now being asked to designate their bonds as bank qualified by investment bankers.

It is suggested that all bonds issued in 1986 may be retroactively designated as bank qualified until January 1, 1988.

SUMMARY

The National Association of Collegiate Directors of Athletics ("NACDA") urges this Committee to expand the scope of Section 1608 of the Tax Reform Act, rather than repealing it, per Section 116(b) of the Technical Corrections Act of 1987.

Section 1608 reflected -- albeit only for two schools -- the ill-conceived policy behind Revenue Ruling 86-63, a policy of the Internal Revenue Service raising questions dealing with contributions tied into athletic ticket purchases.

The reasons are myriad for overturning the Revenue Ruling, most significantly that the IRS had no conception of the framework of the industry it was "regulating." Administrative chaos attends attempts to comply with the Ruling. In addition, substantive policy reasons also exist for reversing the I.R.S.

BARAFF, KOERNER, OLENDER & HOCHBERG, P. C.
ATTORNEYS AT LAW

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
205 Dirksen Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the National Association of Collegiate Directors of Athletics ("NACDA"), I wish to respond to the opportunity to submit comments on S. 1350, the Technical Corrections Act of 1987.

NACDA wishes to express its views on Section 116(b) which repeals Section 1608 of the Reform Act. It is NACDA's position that rather than "rolling-back" the two institutions identified in Section 1608, the Technical Corrections Act ought to "roll-up" all collegiate athletic programs, by overturning Revenue Ruling 86-63.

Background

Revenue Ruling 86-63 itself was issued on April 28, 1986, in an effort to "clarify, distinguish, and supercede" an earlier Revenue Ruling (Rev. Rul. 84-132) which had raised questions about any contribution tied into collegiate athletic ticket purchases. In fact, what the new Revenue Ruling did was to continue the total disallowance of contributions in sold-out stadiums and raise significant evaluation and administrative questions in other facilities.

In the 99th Congress, an amendment to roll-back Revenue Ruling 86-63 was introduced by Senator Pryor on the very day that the Ruling was issued. Shortly thereafter, in the House of Representatives, the same bill was offered by Representative Dicks. Moreover, in the course of consideration of the Tax Revision Bill, Senator Symms drafted a much more comprehensive overturning of the effect of the Revenue Ruling. Conference Committee efforts by Senator Long and Representative Pickle to obtain relief for all of college athletics from the impact of the Revenue Ruling were unsuccessful. Unable to achieve that broad exemption, Senator Long and Representative Pickle -- in an effort to express the bad policy behind the Ruling -- sought some relief for their "constituent institutions" -- Louisiana State University and the University of Texas. Subsequently, House Concurrent Resolution 335 proposed to strike Section 1608, but was never passed.

In the 100th Congress, Senator Gramm has introduced S.74 and Representative Pickle has introduced H.R. 1106, both of which would extend the exemption from Revenue Ruling 86-63 to all schools.

Need For The Legislation

It is estimated that approximately $125 million is contributed yearly to Preferred Seating Plans at some 150 colleges and universities around the country. It is believed that approximately three-quarters of all major athletic programs are involved with Priority Seating Plans. The Plans enable donors to buy preferential seating at collegiate sporting events. Revenue Ruling 86-63 totally disallowed certain contributions and raised significant evaluation and administrative questions in other facilities.

Two principal problems emerged from the Revenue Ruling: Contributions tied into ticket purchases in sold-out stadiums were denied completely as a deduction and the administrative problems attached to non-sold-out stadiums were so chaotic that both schools and taxpayers ignored the law.

Substantively, as a result of the position of the Internal Revenue Service, there ultimately will be a significant diminution of contributions, thereby injuring not football and basketball (those sports usually associated with the Plans), but non-revenue and women's sports.

(a) Administrative Chaos

The college Athletic Directors have made a compelling case that the Ruling simply creates extreme administrative problems. It is apparent that the IRS just did not understand the collegiate sports industry and how the Ruling would affect it. Among these:

* Since a sold-out facility triggers a "death penalty" of no deduction whatsoever, universities will begin holding back tickets for day-of-game sale where a stadium or arena is normally sold out.

* Some universities tie tickets into gifts to the university, rather than to the athletic department, raising much broader policy questions.

* The IRS did not realize that contributions tied to ticket purchases are made, not on a one-time basis, but on a yearly basis, thereby creating annual administrative problems.

* The vast bulk of plans -- approximately 85% -- involve a "grandfathering" problem, where a $300 per year contributor may be sitting next to a $1000 per year contributor sitting next to a $500 per year contributor sitting next to a $50 per year contributor -- all based on when they joined the plan. This factor apparently was not considered by the IRS.

* Since each solicitation must identify the specific amount which can de deducted, a university may be called upon to examine every ticket purchased in a Priority Seating Plan. And this could be required every single year, based on changing factors. One university, for example, would be required to make a yearly analysis of the 17,000 participants in its Plan because of the grandfathering problem.

* A university deciding to use a flat percentage does not meet the specifics of the Revenue Ruling which requires an analysis of

  the level of demand for tickets, the general availability of seats, the relative desirablity of seats based on their types, locations, and views, and other relevant factors.

* An institution that decides to use a flat amount (e.g., $75 per ticket) throughout the entire facility likewise would not meet the specifics of the Revenue Ruling. Moreover,

using that across-the-board $75 evaluation, our hypothetical grandfathered contributors now have the following deductions:

Contributor	Contribution	Non-Deductible	Deductible
A	$ 300	$75	$225
B	$1000	$75	$925
C	$ 500	$75	$425
D	$ 50	$75	[$25 in imputed income?]

* Exacerbating this situation, the IRS obviously did not consider a very common problem that arises with collegiate basketball tournaments and most football programs. Collegiate basketball tournaments, like the Atlantic Coast Conference Tournament, the Big Ten Tournament, the Big East Tournament, and so forth, have become stellar, sold-out events. In the ACC, for example, one cannot even hope to get access to a Tournament ticket, unless you are one of the season ticket holders at one of the ACC schools. Given that fact, each ACC school is required to make the first-cut allocation as to how much of the contribution should be attributed to access to a Tournament ticket (or the possibility of obtaining a Tournament ticket) and allocate the rest to regular season. Of course, the amount attributable to the sold-out Tournament is totally non-deductible -- but what is it worth? The same type of situation occurs in football when School A, for example, might expect to sell-out the School B game, but not the School C contest.

* Some sports, such as hockey, defy the ability to set standards for the benefit received, since there is no commonly-accepted view of what are the best seats.

* The schools face a Catch-22: If the institution estimates the non-deductible portion of the contribution too <u>high</u>, it runs the risk that a donor will be much more wary of giving, since less will be deductible. On the other hand, if the institution values the benefit too <u>low</u>, it runs an even greater risk that the donor might be audited as a result of advice of the institution.

* It is the successful program -- those that sell tickets --that are the most subject to injury under it. A university that might sell out both its football and basketball home games will find itself telling its contributors that no part of any contribution is deductible; on the other hand, the unsuccessful programs that don't work at selling tickets don't have to worry about non-deductibility of charitable contributions. An equally anomalous result occurs if one institution's football season is sold out, but basketball is not. The college is put in the position of telling contributors to football that their contribution is <u>not</u> deductible, while a contribution to basketball <u>is</u> deductible, creating confusion in gift-giving.

(b) Policy Rationale

Ultimately donations will be reduced as a result of the ill-conceived policy. This will have various impacts.

* Charitable contributions -- imperative to fund non-revenue (i.e. minor and women's) athletics -- will drop

significantly if they cannot be written off. A University of North Carolina study showed that more than 50% of donors to athletic programs identify tax considerations as "very important" or "important" in their giving.

* Since most college athletic programs are required to be fully funded from their own activities, any shortfall as a result of reduced contributions will be made up by going to the institution's General Fund; this in turn will be funded by the taxpayers generally. Alternatively, the shortfall will result in the dropping of certain athletic programs, which generally will be non-revenue minor sports and/or women's athletics. As a result of the financial crisis, schools have already begun dropping sports.

* The legislative resolution is limited in its scope -- and therefore in its revenue impact. At the specific request of Representative Pickle, an examination was made of legal, economic, and policy implications of expanding the charitable contribution bill to cultural events. See letter of February 9, 1987. It was concluded that other industries simply are not affected in the same way as collegiate athletic Preferred Seating Plans, that no cultural "preferred seating programs" existed, that the economics were totally dissimilar, and that those industries have the ability to "expand their capacity" by more performances, a solution not available to college football, for example. We concluded:

> ...[T]he expansion of the scope of [the legislation] may raise questions that do not have to be raised in the economics of an industry [cultural events] that has not sought and will not necessarily benefit from the additional exemption.

For the above reasons, the National Association of Collegiate Directors of Athletics respectfully requests the expansion, not the contraction (or repeal), of Section 1608 of the Tax Reform Act.

Sincerely,

Philip R. Hochberg

National Association of Home Builders

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

The National Association of Home Builders (NAHB) appreciates this opportunity to present its comments on the Technical Corrections Act of 1987 (S.1350). We request that these comments be included in the hearing record of the Finance Subcommittee on Taxation and Debt Management.

First, we would like to note that several positive provisions are contained in S.1350. These include the following items:

o Clarification that income received after 1986 from installment sales of passive activities before 1987 can be used to offset passive activity losses;

o The treatment of interest on indebtedness secured by a qualified residence and incurred after August 16, 1986, to refinance grandfathered indebtedness as qualified residence interest;

o Several changes designed to make the low-income housing tax credit more workable; and

o Disallowance of a separate fee to be charged in connection with the real estate transaction information reporting requirements.

These, and other changes proposed in S.1350 will provide for a smoother transition to the new tax law. However, there are several other concerns that NAHB feels should be addressed. Admittedly, some of these concerns may be considered to go beyond the scope of technical corrections. However, they are in urgent need of being addressed legislatively. NAHB's concerns are described below:

<u>Contributions in aid of construction</u>

One of the major problems confronting home builders as a result of the Tax Reform Act of 1986 is the taxation of contributions in aid of construction (CIAC). Prior to the 1986 Tax Act, CIAC was not treated as taxable income to the recipient utility company. Rather, CIAC was treated as a nontaxable contribution to capital. The builder making the contribution could not deduct the payment made to the utility company. Likewise, the utility company could not depreciate any property it received.

As a result of the 1986 Tax Act, investor-owned utility companies now must include CIAC in income. The additional cost that results from taxing CIAC, basically, can be handled in two ways. The cost can be passed on to the builder, or the cost can be passed on to the utility's customers in the form of higher rates. Our experience has been that, at least initially, the cost is being passed on to the builder. In general, utility companies have been "grossing up" their additional tax costs to builders. Assuming a 40 percent Federal income tax rate for the utility company, this amounts to a 67 percent cost increase for the builder. Thus, by and large, builders are not only making contributions to utility companies, they are also paying the tax on the contributions. In order for the builders to come out whole, they must increase the price of the homes they are selling, thus forcing many would-be home buyers out of the market. Many builders must cut back new home construction drastically because they do not have the means to come up with the funds necessary for paying the tax incident to CIAC. Of course, in areas that are served both by investor-owned utilities and governmentally-owned utilities, builders can avoid the problem by taking their business to governmentally-owned utilities, which are not taxed. However, this puts the investor-owned utilities at a competitive disadvantage.

NAHB believes that the only fair way to resolve this problem is to restore prior law. However, short of such action, there are several technical corrections that can be made to mitigate the results somewhat. For example, Congress could clarify that relocation expenses (e.g., the movement of a water main from one location to another) are not CIAC. Furthermore, it could be provided that where the tax is "grossed up" to the builder, the gross up should take into account the present value of depreciation deductions with respect to the contributed property (or the property purchased with contributed money). Finally, the contribution could be treated as an ordinary and necessary business expense deductible in the year of the contribution. This would be only logical since the contribution is treated as taxable fully in the year of receipt.

Tax-credit for low-income rental housing

NAHB believes that the tax-credit for low-income rental housing was one of the highlights of last year's tax reform effort. Although the final product was far from perfect, the enactment of the credit at least indicated Congress' belief that a tax incentive must be provided to encourage construction, rehabilitation, and maintenance of low-income housing. S.1350 contains several changes designed to make the low-income housing tax credit more workable, but several more changes need to be made.

A major problem with the low-income housing tax credit is that the median income levels in many low-income rural areas are so low that owners of housing projects who want to utilize the tax credit are finding such projects to be economically unfeasible. This problem is caused by the fact that a project's rents are tied to area median gross income. This problem could be mitigated by allowing the use of the higher of statewide or area median gross income. This is the same criterion used for determining income eligibility under the mortgage revenue bond program.

The bill would permit carry-forwards of low-income housing tax credit allocations to the succeeding taxable year if the Secretary of the Treasury determines that it was reasonable to believe that the building would be placed in service during the allocation calendar year and that the delay was caused by unforeseen conditions which were not within the control of the taxpayer. We believe that this standard is too vague. Thus, we recommend that the bill's carryover provisions be expanded to provide a safe harbor for projects receiving allocations of low-income housing tax credits for years after 1987 where at least 50 percent of the total building costs have been expended by the end of the allocation year and the project is placed in service no later than the close of the subsequent calendar year.

Low-income housing projects that have been placed in service within the preceding ten-year period are not eligible for the four percent credit for acquisition costs. However, the Code provides an exception for certain Federally-assisted projects if a waiver is necessary to avoid an assignment of the mortgage to HUD or the Farmers Home Administration or to prevent a claim against a federal mortgage insurance fund or "by reason of other circumstances of financial distress." The bill deletes the quoted language. We urge that the statute be broadened in three ways: First, waivers should be permitted for all distressed Federally-assisted and Federally-insured projects. Second, the bill should provide that waivers will be available upon the certification of HUD or FmHA in the case of Federally-insured or Federally-assisted projects, or of a comparable state or local agency in the case of Federally-assisted, state-or local-financed projects. Third, the bill should maintain the present Code allowance of waivers for reasons of financial distress and expand the authority to grant waivers if necessary to preserve low-income rental housing.

The Code provides for recapture of low-income housing tax credits taken in prior years if an investor disposes of his or her interest in a low-income housing project. A special rule is provided for partnerships consisting of 35 or more partners, under which the partnership may elect to be treated as the taxpayer for purposes of recapture as long as no more than 50 percent of the interests, calculated by value, are transferred within any 12-month period. The bill would limit this special rule to partnerships in which more than 1/2 the capital interests, and more than 1/2 the profit interests, are owned by a group of 35 or more partners each of whom is a natural person or estate. Basing qualifications for this special rule on an ongoing specified percentage of ownership by individuals, as opposed to corporations, would require large public partnerships to calculate continuously their percentages of corporate and individual ownership and would impose needless additional record-keeping burdens. We suggest that the bill be amended to provide that the percentage ownership interests need be met only at the time the partnership makes the election to be treated as the taxpayer. With respect to the availability of the election for investment partnerships in two-tier arrangements, the bill should specify that the election may be made by a partnership that holds a majority interest, directly or through another entity, in a qualified low-income housing project.

There are special provisions in the low-income housing tax credit that facilitate the development of projects targeted to very low-income tenants (at or below 40 percent of area median income). To qualify, at least 15 percent of the low-income units must be rented to very low-income tenants and gross rents on the market rate units must be at least three times gross rents on the low-income units (the "three to one ratio"). The bill clarifies that for purposes of determining whether a project complies with the gross rent limitation applicable to the low-income housing tax credit, Section 8 housing assistance payments are not counted. However, for purposes of determining whether the three to one rent ratio is satisfied, such rental assistance payments are counted. Thus, Section 8 and similarly assisted projects are effectively precluded from qualifying under the deep rent skewing provision because with such assistance payments, the market rents will not be three times the low income rents. Accordingly, the bill should be amended to make the treatment of Section 8 and similar rental assistance payments consistent in the deep rent skewing provisions. That is, such payments should be disregarded for purposes of determining whether the three to one ratio is satisfied.

The Code provides that the eligible basis of any building for the entire 15-year compliance period is determined on the date the building is placed in service. This provision creates a serious problem where expenditures are incurred by an owner of a newly constructed building after a project is opened for occupancy. The bill should specify that the eligible basis of a building is determined at the time that the building's qualified basis is determined. Qualified basis is determined on the last day of the taxable year in which the building is placed in service, or if the taxpayer elects, on the last day of the succeeding taxable year.

In order to utilize the low-income housing tax credit with existing housing, the building must be acquired. A problem arises when prospective purchasers want to purchase the partnership interests of a partnership owning an otherwise qualified building instead of buying the building itself. This problem regarding the acquisition credit can be cured by providing that either a building or not less than 90 percent of the interests of the partnership owning the building could be acquired.

The base, against which the amount of the low-income housing tax credit is calculated, is reduced by the amount of the nonqualified nonrecourse financing outstanding with respect to the property at the end of the taxable year. In general, nonrecourse financing is nonqualified if the property was acquired from a related person. It is not uncommon for the owner of a project to have also been the builder. If the builder owned more than a 10 percent interest in the property, and the property was financed with nonrecourse financing, the nonrecourse financing would be nonqualified. The bill should be amended by eliminating the requirement that the property be acquired from an unrelated person for purposes of determining the credit base for the low-income housing credit.

Passive loss rules

The passive loss rules generally do not apply to a taxpayer when he or she is a material participant in the activity. However, for purposes of the passive loss rules, rental real estate is deemed to be a passive activity. Deeming rental real estate to be a passive activity means that, with the limited exception provided for active participants in rental real estate, even those who are material participants in the activity are subject to the passive activity loss limitation. This is patently inequitable. NAHB is not urging that passive investors should have unlimited benefits through investment in rental real estate. Rather, we are merely urging that those who are material participants in the rental real estate business should be treated the same as those who are material participants in any other trade or business activity. Thus, a taxpayer who materially participates in rental real estate should not be subject to the passive activity loss limitation. Admittedly, to make the passive activity loss rules fair for rental real estate would take more than a technical correction. However, we urge you, as soon as possible, to make changes to the passive loss rules that do not treat rental real estate in an arbitrarily unfair manner.

The Tax Reform Act of 1986 contains necessary transition relief for certain low-income housing activities. In general, losses from certain investments made after 1983 and before 1987 are "grandfathered" from the passive activity loss restrictions for a period of up to seven years from the date of the taxpayer's original investment. We urge that this transition rule be broadened slightly. Specifically, the transition rule for low-income housing should be amended to provide that low-income housing placed in service between January 1, 1984 and December

31, 1986 is grandfathered for a period of seven years from the date of the taxpayer's original investment if such low-income housing, or any interest therein, is acquired or purchased by December 31, 1987. This change is necessary because many low-income housing projects that were placed in service last year were unable to be syndicated due to the tremendous uncertainty caused by the tax reform process. We also suggest that the transition relief be available to investors without regard to whether they are required to make payments after December 31, 1986 of 50 percent or more of their obligated investment. This is an arbitrary requirement that discriminates against investors who paid in their contributions early.

Personal interest limitation

The Tax Reform Act of 1986 eliminated deductions for personal interest expenses. However, qualified residence interest remains deductible. We propose that the definition of qualified residence interest be expanded to include interest paid or incurred in connection with the purchase of land upon which the taxpayer intends to construct a qualified residence. Moreover, interest on a loan to construct a qualified residence should be deductible. Under present law, a taxpayer who has purchased land to construct a home is at a serious disadvantage because he has no qualified residence against which to secure a loan. Thus, we urge you to make this correction.

NAHB appreciates this opportunity to submit its comments on technical corrections to the Tax Reform Act of 1986. We look forward to working with the Committee as it considers this important legislation.

Sincerely,

National Association of Home Builders

National Conference of State Legislatures

Outline of Testimony

Regarding the Technical Corrections Act of 1987

- Exemption for State and Local Employees from Mandatory Distribution of Pension Benefits at Age 70 1/2:

    - Conflict between TRA and the Age Discrimination in Employment Act of 1985 which eliminated forced retirement at age 70 created situation where an employee could simultaneously earn full salary, receive retirement benefits and accrue additional retirement credits.
    - Most states and localities require an individual to retire as a prerequisite to commence pension benefits.
    - 70 1/2 distribution poses additional fiscal responsibilities upon states and localities by increasing pension liabilities.
    - 70 1/2 distribution will increase complexity of record keeping and computation requirements of employee benefits for state systems by requiring continual adjustment of pension benefits and accruals with any fluctuation in salaries.
    - If distributions do not begin upon 70 and a half, an employee will be subject to a 50 percent excise tax.
    - Purpose of mandate was to address tax sheltering of income for estate planning by highly compensated private sector individuals.
    - Problem of tax sheltering unique to private sector.

- Mitigate Negative Effects of the Repeal of the Three Year Recovery Rule on State and Local Employees:

    - Most public pension plans require an employee to make after-tax contributions to retirement unlike other retirement savings vehicles.
    - Suddenness of repeal of three year recovery rule did not give public employees adequate time to plan for change in distribution of pensions benefits.
    - Repeal of three year recovery rule for employees retiring after July 1, 1986, but before January 1, 1988, resulted in double penalty with the loss of three year recovery rule and taxation at the higher pre-TRA tax rates.
    - Inflexible and inadequate Treasury regulations have complicated and increased administrative burden for public retirement systems.

- Ensure that Deferrals to State and Local 457 Plans Are Treated As Non-Elective:

    - Treasury has announced will violate Congressional intent on treatment of non-elective deferrals by treating them as elective deferrals.
    - Unlike elective deferrals, Non-elective deferrals are outside the employee's control.
    - Treasury proposes to treat non-elective deferrals such as vacation leave, sick leave, survivors' benefits and severance pay as elective deferrals.
        - Proposal would accelerate and inflate an employee's contribution to retirement.
        - Proposal may cause an employee to violate yearly $7,500 limit on retirement contributions.
        - Treasury proposes retroactive application of broader definition back to 1978.
        - Contributions over $7,500 limit would be subject to 10 percent excise tax.

TESTIMONY OF

REPRESENTATIVE KEVIN P. BLANCHETTE

Chair, Joint Public Service Committee

Commonwealth of Massachusetts

Chair, NCSL Pensions Subcommittee

ON BEHALF OF THE

NATIONAL CONFERENCE OF STATE LEGISLATURES

SUBMITTED TO THE

TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE

FINANCE COMMITTEE

UNITED STATES SENATE

WASHINGTON, D.C.

REGARDING THE TECHNICAL CORRECTIONS ACT OF 1987

JULY 22, 1987

Mr. Chairman, my name is Kevin Blanchette. I am a member of the Massachusetts House of Representatives and Chairman of the Joint Public Service Committee. I also serve as the Chair of the NCSL Pensions Subcommittee. On behalf of the National Conference of State Legislatures, thank you for this opportunity to testify before you on pension issues for the Technical Corrections Act of 1987 (H.R.2636 and S.1350) to the Tax Reform Act of 1986 (TRA), P.L.99-514.

The most comprehensive tax overhaul in this country's history has left state government with the onerous task of analyzing tax reform's impact on state and local public pension systems and employees.

The broad scope of tax reform produced unintended consequences for public employee retirement systems and employees of state and local governments. Specifically, the National Conference of State Legislatures (NCSL) has identified as grave concerns:

- the mandate of distribution of pension benefits at age 70 and a half (Section 1122) which preempts state retirement policy and potentially jeopardizes the fiscal integrity of state retirement systems;

- the repeal of the three year recovery rule (Section 1121) which penalizes public employees who make after-tax contributions to retirement; and

- the U.S. Department of Treasury interpretation of the modifications to Section 457 (Section 1107) which jeopardizes the deferred tax status of elective contributions to retirement by broadening the definition of an elective contribution to include factors outside of the employee's ability to control.

Exempt State and Local Governments From Mandatory Distribution of Pension Benefits At Age 70 and a Half:

NCSL urges Congress to exempt state and local governments from TRA's mandatory distribution of pension benefits at age 70 and a half. With the passage of TRA and the Age Discrimination in Employment Act of 1986, which eliminated forced retirement at age 70, a situation was created where an employee could simultaneously receive full salary, draw retirement benefits and accrue additional retirement credits. The conflict between the two laws preempted many state retirement policies which provide, by statute, that retirement is a prerequisite for commencement of pension benefits.

Because Americans are living longer, healthier lives and many are working out of economic necessity, more employees are choosing to continue working long after "normal" retirement age. TRA's mandate will, therefore, significantly increase state pension funding requirements and the amount of time needed to finance pension benefits.

Retirement systems must immediately begin planning for the 70 and a half mandate of increased pension benefits for the 20 to 40 year olds currently in our work force. The 20 to 40 year olds, or the baby boomers, constitute a third of the nation's population. In 20 years, all retirement systems will feel the burden of an estimated 10 million baby boomers reaching retirement age. By the year 2030, it is estimated all of the baby boomers will have reached retirement age.

The 70 and a half mandate will put a financial burden on state and local public retirement systems at a time when many systems will be unable to shoulder this unwarranted additional fiscal responsibility. To date, twenty-four states have reported budget reductions and at least 11 states have enacted tax increases in order to meet constitutional mandates of a balanced budget.

TRA's mandate will, for example, add an $87.4 million pension liability to the budget of the State of Texas.[1] This liability would be imposed at a time when Texas is trying to balance its budget while providing essential services with dwindling revenues.

Although my state of Massachusetts is one of the few states still enjoying a modest revenue surplus, we are beset by an unfunded pension liability totaling over $11 billion, a debt that will only worsen with this new federal requirement.

Because most states base retirement benefits on years of service and final salary computations, distribution of pension benefits at age 70 and a half will increase the complexity of record keeping and computation requirements of employee benefits for state systems by requiring continual adjustment of pension benefits and accruals with any fluctuation in salaries.

If the 70 and a half mandate is not met, public employees will be put in the precarious position of potentially losing half of their monthly retirement check. This would be, in effect, a 50 percent federal excise tax. This excise tax poses a substantial reduction for public employees who are dependent upon their retirement income to make ends meet.

The rule of mandatory distribution at age 70 was enacted in order to preclude highly paid private sector individuals from using retirement savings plans as vehicles to shelter income in estate planning. Few public employees are highly compensated. In Massachusetts, a state employee earns on average, a moderate yearly income of $25,200. Because most state employees are dependent upon their pensions to provide income during retirement, they usually do not have the luxury of delaying the start of their pensions. Moreover, the tax sheltering mechanism used by highly compensated private sector employees is simply unavailable to most public workers. NCSL believes that the financial security of state employees and retirement systems should not be jeopardized by TRA's scatter-gun approach to a private sector problem.

Mitigate Negative Effects of Repeal of the Three Year Recovery Rule on State and Local Employees:

We urge Congress to mitigate the negative effects of the repeal of the three year recovery rule on the employees and retirement systems of state and local governments. Because most state pension plans require after-tax contributions of their employees, the repeal of the three year recovery rule has had a substantial impact on the public sector.

Unlike other retirement plans, employees participating in these state and local pension plans are unable to defer or deduct their contributions to retirement savings from federal income tax. Instead, their contributions must be made on an after-tax basis. To reconcile this disparity in tax treatment, the federal government had permitted public employees to accelerate the recovery of their previously taxed contributions in the first three years of receipt of pension benefits.

With the enactment of TRA, the three year recovery rule was retroactively repealed for all employees retiring after July 1, 1986. The new basis recovery rule, which requires public employee after-tax contributions to be proportionately recovered over the life of the annuity, does not recognize the disparity between tax treatment of public employee pension contributions and that of other retirement savings contributions.

The retroactive nature of the repeal is grossly unfair to state and local employees who retired after July 1, 1986, but before January 1, 1988. In essence, those individuals suffer a double penalty of the loss of the three year recovery rule under the new tax law and taxation at the higher, pre-TRA tax rates.

Secondly, the unexpected repeal of the three year recovery rule did not allow public employees adequate time to plan for the change in the tax treatment of their pension benefits. Because of the suddenness of the repeal, the financial security of many retiring state and local employees was impaired.

The new basis recovery rule and U.S. Department of Treasury regulations are inflexible and do not adequately address the variety of benefit options and types of benefits that determine the amount of an employee's pension benefits. For Massachusetts' state retirement system and the 101 local pension systems, Treasury's regulations do not consider the complicated nature and combination of types of benefits and various benefit options that state or local systems may offer.

We urge you to mitigate the negative effects of the repeal of the three year recovery rule and the onerous administrative requirements of the new basis recovery rule on state and local employees and retirement systems.

Ensure that Deferrals to State and Local 457 Plans Are Non-Elective:

NCSL calls upon Congress to clarify the law to ensure that employee contributions to non-elective, unfunded deferred compensation plans of state and local governments and tax-exempt organizations under Section 457 are not subject to taxation until the benefit is actually distributed to the employee.

The U.S. Department of Treasury announced its intent to broaden the definition of an elective deferral to include deferrals based on factors outside of the employees' control in Internal Revenue Bulletin No. 1987-4. With this broader interpretation, the Department of Treasury has clearly violated the legislative history and intent of Congress. By definition, a non-elective deferral is one over which the employee has no control, such as one set by an employer based on such factors as salary or years of service.

For state and local employees, this means vacation leave, sick leave, survivor benefits, and even severance pay could now be considered in the $7,500 yearly limit on contributions to 457 retirement plans. These non-elective benefits would inflate and accelerate an employee's contribution to retirement and potentially cause an employee to violate the yearly $7,500 limit on retirement contributions. Any contributions over the $7,500 limit would be penalized with a 10 percent excise tax.

In addition, Treasury's proposed retroactive treatment of what it considers to be deferred contributions could potentially result in the retroactive taxation of an employee's contributions to retirement and in the taxation of other employee benefits which the employee may never have the benefit of actually receiving.

Conclusion

In 1986, the Congress rewrote the nation's tax laws to provide a more equitable and simple form of taxation. However, for the employees and retirement systems of state and local governments, tax simplification was not simple.

In many cases, the consequences of tax reform pose serious threats to the fiscal integrity of state pension systems and the retirement plans of millions of state and local workers. The nation's 50 state legislatures are struggling to address these problems. We ask that you recognize the distinct character of state and local governmental employment and permit state and local governments the flexibility to effectively manage their work force by correcting the problems caused by the Tax Reform Act.

[1]Clayton T. Garrison, Executive Director of Texas Public Employees' Retirement System, to Robert J. Leonard, Washington, D.C., 6 July 1987.

COMMENTS REGARDING TECHNICAL CORRECTIONS ACT OF 1987

Set forth below are the comments of the National Association of Bond Lawyers regarding the tax-exempt bond provisions contained in the Technical Corrections Act of 1987, introduced on June 10, 1987. These comments are divided into three categories: (1) comments regarding the need for clarification of certain technical corrections; (2) comments regarding substantive change caused by certain technical corrections; and (3) comments regarding other required technical corrections.

As used herein, the term "Bill" means the Technical Corrections Act of 1987, introduced as S.1350 in the United States Senate and H.R. 2636 in the United States House of Representatives. The term "Act" means the Tax Reform Act of 1986. The term "1986 Code" means the Internal Revenue Code of 1986 as enacted by the Act. The term "1954 Code" means the Internal Revenue Code of 1954. The term "Explanation" means the "Description of the Technical Corrections Act of 1987," released by the staff of the Joint Committee on Taxation on June 15, 1987. The term "Blue Book" means the "General Explanation of the Tax Reform Act of 1986" released by the Staff of the Joint Committee on Taxation on May 8, 1987.

TECHNICAL CORRECTIONS REQUIRING FURTHER CLARIFICATION

Small Issuer Exemption from Rebate: Entities Formed for Application of Exemption. Section 113(a)(17)(A)(iii) of the Bill adds clause (ii)(III) to section 148(f)(4)(C) of the 1986 Code indicating that, in determining the application of the small issuer exemption from rebate, there must be included "an entity formed (or, to the extent provided by the Secretary, availed of) to avoid the purposes of" the small issuer exemption from rebate. Clause (ii)(III) should be deleted from the amendment made by section 113(a)(17)(A)(iii) of the Bill.

The inclusion of clause (ii)(III) implies that citizens will form local government units with general taxing powers solely for the purpose of application of the $5,000,000 exemption from rebate. This is highly unlikely and, even if true, is not possible of determination. Formation documentation will not indicate purposes for formation beyond governmental purposes, bond counsel will not be capable of applying the provision and the Internal Revenue Service will not be capable of enforcing the provision.

Small Issuer Exemption from Rebate: Certain Current Refunding Bonds. Section 113(a)(17)(A)(iii) of the Bill adds clause (iii) to section 148(f)(4)(C) of the 1986 Code indicating that, in determining the application of the small issuer exemption from rebate, there shall not be taken into account "any bond issued to refund (other than advance refund) any bond to the extent the amount of the refunding bond does not exceed the outstanding amount of the refunded bond." (Emphasis added.) Application of the underlined phrase is unclear. If a refunding bond is issued in the amount of $4,000,000 to refund the $3,000,000 outstanding amount of a prior bond, does clause (iii) mean that the entire $4,000,000 refunding bond must be counted in determining the application of the exemption because the principal amount of the refunding bond exceeds the outstanding principal amount of the refunded bond? Or does clause (iii) mean that only $1,000,000 of the refunding bond must be counted in determining the application of the exemption? If the former meaning is intended, the word "if" should be substituted for the underlined phrase.

Change in Use Provisions Applied to Small Issue Private Activity Bonds. Section 113(a)(23)(A) of the Bill amends section 150(b)(4)(B) of the 1986 Code by inserting the phrase "or a qualified small issue bond" indicating that the change in use provisions apply to terminate interest deductibility for small issue bonds in the case of facilities financed with such bonds "if such facility is not used for a purpose for which a tax-exempt bond could be issued on the date of such issue" (Section 150(b)(4)(A) of the 1986 Code). The Explanation indicates, as one example of a change in use for a small issue bond, a post-issuance capital expenditure which results in violation of the $10,000,000 limitation applicable to small issue private activity bonds. It is strenuously objected that such a capital expenditure is not a change in "use"; rather a change in use would result, for example, from use for a commercial purpose of a facility financed with bonds exempt by reason of an original use for a manufacturing purpose. If it is intended that violation of the $10,000,000 result in a loss of the interest deduction, Section 113(a)(23)(A) of the Bill should specifically so indicate.

Improper Code Reference. Section 113(c)(12)(A) of the Bill relates to an amendment to subparagraph (N) of section 103(b)(6) of the "1986 Code." The reference to the Code should be changed to the "1954 Code," as was done in section 113(c)(12)(B) of the Bill.

Extension of Origination Period for Current Refundings of Qualified Mortgage Bonds. In discussion of the extension of the 1954 Code sunset date for issuance of qualified mortgage bonds and bonds issued to refund qualified mortgage bonds, the Explanation states on page 244, ". . . refundings permitted under this expansion of the transitional exception may not involve an extension of the period for providing financing to homebuyers." A similar statement was contained in the Conference Report, published September 18, 1986, on page II-716 and in the Blue Book on page 1230. The statement is not supported by specific statutory language in either the Act, the 1986 Code or the 1954 Code.

Congress, in both the 1986 Code and in the 1954 Code, placed certain limitations upon the type and amount of qualified mortgage bonds and mortgages acquired with qualified mortgage bonds, as well as certain limitations upon arbitrage earnings. In none of these limitations is there a limitation upon the period during which mortgages can be originated. It is clearly unacceptable for the Explanation to indicate a limitation where there is none.

SUBSTANTIVE CHANGES MADE BY BILL

Measure of Issuance Costs Limitation and of Safe Harbor Exception from Rebate. Section 113(a)(13) of the Bill amends section 147(g) of the 1986 Code to apply the limitation on issuance costs against the "proceeds" of the bonds, rather than against the face amount of the bonds as is now set forth in section 147(g) of the 1986 Code. Similarly, section 113(a)(16) of the Bill amends section 148(f)(4)(B)(iii)(I) of the 1986 Code to apply the measure of the cumulative cash flow deficit against the "proceeds" of the bonds, rather than against the face amount of the bonds as is now set forth in section 148(f)(4)(B)(iii)(I) of the 1986 Code. Although not set forth in the 1986 Code, staff has indicated that the term "proceeds" means an amount equal to the reoffering price of the bonds to the public. Such changes are substantive changes not appropriately made by a technical corrections act.

Many issuers sell their bonds at public sale after bidding. Under this arrangement, the issuer will cause the official statement to be prepared and printed, will cause notice of bids to be published two to three weeks prior to the bid opening, will receive bids and award the bonds to the winning bidder at the bid opening and will issue the bonds one to three weeks following the award of the bid. Under this procedure, the principal amount of the bonds must be determined prior to the time that the official statement is printed and the bids on the sale of the bonds are received, yet the amount of "proceeds" of the bonds is not known until after the winning bidder at the public sale resells the bonds to the public.

If, for example, an issuer determines that the principal amount of tax and revenue anticipation notes to be sold at public sale will be $10,000,000, based upon a projected safe harbor cumulative cash flow deficit of $9,000,000 and if, following public sale of the bonds, the winning bidder indicates that the notes were resold to the public at an original issue discount of one percent, the "proceeds" of the notes would be $9,900,000 and on the date of delivery of the notes, the issuer would know that if its projected cumulative cash flow deficit becomes the actual cash flow deficit, the "safe harbor" for rebate purposes will not be achieved because the projected deficit will exceed 90 percent of the reoffering price of the notes. The modifications suggested by the Bill have a substantive effect upon issuer procedures for bond sale, may force the negotiated sale of bonds or anticipated to be issued) during the same calendar year cannot exceed $10,000,000. Under the deemed designation route, the issue must pass muster under a different set of standards: specifically, the prior bonds must themselves have been QTEO's, and the refunding must be a "non-advance" refunding which does not exceed the outstanding amount of the prior bonds and which complies with specified maturity limits. The deemed designation route does not, however, require the issue to take into account other bonds issued during the calendar year. Thus an issuer using the deemed designation provisions can preserve the QTEO status of a financing through one or more refundings even though there are other financings during the year of the refundings such that the refunding bonds could not qualify outside the deemed designation provisions.

The Explanation states that the deemed designation provisions are the only route by which a refunding issue can achieve QTEO status. In other words, the Explanation takes the position that a refunding issue cannot be a QTEO issue unless the prior issue "was designated, qualified for, and was taken into account under the $10 million limitation when issued." (Page 76.) This comment by the Explanation is not supported by the statutory language of the Bill, which as noted above permits refunding bonds to qualify either by actual designation or by deemed designation. Further, the rule proposed by the comment is not justified by any sensible policy. It is inappropriate to deny an issuer which issued bonds prior to the effective date of the 1986 legislation the opportunity to refund them with QTEO's, provided the refunding bonds meet the tests set forth for refunding bonds as described herein.

REQUIRED ADDITIONAL TECHNICAL CORRECTIONS

Inclusion of "On Behalf Of" Issuers in Small Issuer Rebate Exception. The small issuer exception from rebate requirements contained in section 148(f)(4)(C)(i) of the 1986 Code relates to governmental units with general taxing powers. Congressional staff has indicated that the exception applies to entities which issue on behalf of governmental units with general taxing powers. It is suggested that subclause (I) (as redesignated by section 113(a)(17)(A)(ii) of the Bill) of section 148(f)(4)(C)(i) of the 1986 Code be amended to read as follows (new language is indicated by underlining):

> (I) the issue is issued by or on behalf of a governmental unit with general taxing powers.

It is also noted that there appears no clear legislative purpose to limiting the small issuer exemption to governmental units with general taxing powers. The intent of the exception should be to limit its application to governmental bonds. We suggest, therefore, that consideration be given to the entire elimination of of subparagraph (I).

Change in Use Rules Applied to Transitioned Refundings of Residential Rental Bonds. Section 1313(a) of the Act permits current refundings of certain bonds, including residential rental bonds originally issued as tax-exempt under section 103(b)(4)(A) of the 1954 Code. Subparagraph (E) of section 1313(a)(3) of the Act indicates that the change in use provisions contained in section 150(b) of the 1986 Code apply to such transitioned refunding bonds. Paragraph (2) of section 150(b) of the 1986 Code relates to change in use of facilities financed with bonds issued as tax-exempt under section 142(a)(7) of the 1986 Code and does not refer to facilities financed as tax-exempt under section 103(b)(4)(A) of the 1954 Code. Since it was not the purpose of the transition rule for refundings of residential rental projects to impose the new low income restrictions applicable to bonds issued under section 142(a)(7) of the 1986 Code, subparagraph (E) of section 1313(a)(3) of the Act requires modification to indicate its inapplicability to bonds issued to refund prior bonds issued as tax-exempt under section 103(b)(4)(A) of the 1954 Code. It is suggested that section 1313(a)(3)(E) of the Act be amended by the Bill to read as follows (new language is indicated by underlining):

> (E) Except in the case of bonds issued for facilities qualifying under section 103(b)(4)(A) of the 1954 Code, the provisions of section 150(b) of the 1986 Code (relating to change in use).

the imposition of artificial restraints upon the reoffering price of the Notes. Such substantive provisions are improper points for inclusion in a technical corrections bill.

Application of Rebate Rules to Refunding Bonds. Section 113(a)(17)(A)(iii) of the Bill adds new clause (iv) to section 148(f)(4)(C) of the 1986 Code indicating that, unless certain stringent restriants are satisfied, the $5,000,000 small issuer exemption from rebate requirements does not apply to refunding bonds. Included among these restraints is a requirement that the refunded bonds must have satisfied the $5,000,000 exemption when issued. Thus, if the refunded bond either satisfied the rebate requirement or was exempt from the rebate requirement due to the expenditure exemption or for other statutory reason, the refunding bond would be automatically ineligible for the small issuer exemption. There is no indication in the Act that Congress did not intend for the small issuer exemption to apply to refunding bonds (as well as new money bonds) without limitation, and there is no clear reason for a distinction between bonds which refund prior bonds which complied with rebate requirements and bonds which refund prior bonds which were exempt from rebate requirements, and bonds which are issued for provision of construction funds, acquisition funds, or working capital funds. The distinction which Congress made in the Tax Reform Act of 1986 and which should be maintained without erosion by the Technical Corrections Act of 1987 is a distinction between issuers rather than a distinction between purposes of bond issuance. The exclusion of refunding bonds from the exemption. Proposed clause (iv) of section 148(f)(4)(C) is substantive in effect and highly inappropriate for a technical corrections bill. Proposed clause (iv) should be withdrawn.

Designation of Refunding Bonds. Section 109(b)(5) of the Bill provides reformulated rules to determine whether refunding bonds may qualify as qualified tax-exempt obligations ("QTEO's") for certain bank deductibility provisions and to indicate how refunding bonds are to be taken into account in determining whether other bonds qualify as QTEO's. This comment offers our understanding of the legislative language that the Bill would add to the 1986 Code as section 265(b)(3)(F) and (G) and offers our reasons for concluding that the Explanation fundamentally misrepresents the plain meaning of that language.

Section 265(b)(3)(F) provides a general rule that in determining the status of a non-refunding bonds, a refunding bond will not be taken into account for purposes of the $10 million limit of section 265(b)(3)(C) provided that (1) the refunding is not an advance refunding and (2) the amount of the refunding issue does not exceed the outstanding amount of the refunded issue. Thus an issuer may issue up to $10 million of construction (non-refunding) bonds in a year and designate them as QTEO's notwithstanding the fact that the issuer issues additional amounts of refunding bonds during the year, provided the refunding bonds meet the standards of section 265(b)(3)(F).

Section 265(b)(3)(G)(i) denies QTEO status to any bond that is part of an issue that includes any refunding bonds and exceeds $10,000,000 in aggregate face amount. This rule means that an issuer could not issue a multi-purpose issue of $15 million of which $7 million was refunding bonds and $8 million of construction bonds as QTEO's on the ground that section 265(b)(3)(F) made the $7 million of refunding bonds irrelevant.

Section 265(b)(3)(G)(ii) allows refunding issues that meet the test of section 265(b)(3)(G)(i) to achieve QTEO status through either a regular designation or a "deemed" designation. Under the regular designation route, the refunding issue must meet the general standards applicable to non-refunding issues, such as the limitation of section 265(b)(3)(A) that the total of the designated issue plus all other bonds issued (or

Rebate as Applied to Tax and Revenue Anticipation Noes. Section 148(f)(4)(B)(iii) of the 1986 Code relates to an exemption from rebate for tax and revenue anticipation notes which satisfy a "safeharbor" in terms of cumulative cash flow deficits. Footnote 173 of the Blue Book indicates that it is expected that the Treasury Department will treat deficits as occuring only if no amounts other than bond proceeds are available to pay expenses for that which the proceeds are used. In determining available amounts, amounts in special purpose accounts or otherwise earmarked are available if the governmental unit either (1) established the restrictions on the use of the other funds or (2) has the power to alter the use of the other funds. Footnote 173 indicates a significant expansion of the definition of "available revenues" under existing Treasury regulations.

It is contended that Congress did not intend that present Treasury regulations of "available revenues" be modified when Congress enacted the safe harbor exception to rebate. The Bill should modify Section 148(f)(4)(B)(iii) to include a definition of "available revenues" which is based upon the definition of such term which is included in present Treasury regulations.

Security for Qualified Redevelopment Bonds. Subparagraph (B) of section 144(c)(2) of the 1986 Code relating to the security for qualified redevelopment bonds is unclear. It has been variously stated that existing clause (i) was designed to permit general obligation bonds, real property tax increment bonds, sales tax increment bonds and bonds combining one or more of such sources of security. It has also been indicated that no discrimination between sources of security was intended by the reference in existing clause (i) to "primarily secured by" as contrasted with the reference in clause (ii) to "reserved exclusively for". It has also been indicated that the reference to "reserve exclusively for" was not intended to eliminate state statutory requirements for use of tax increment for, for example, low or moderate income, or to eliminate past and future contracts and other arrangements whereby a portion of tax increment was provided to governmental units not engaged in redevelopment or renewal, for example, to school districts to be used for school purposes, as opposed to its use for bond debt service. The Blue Book indicates that payment of the bonds is not to be "derived from" payments such that the bonds would have been rendered as industrial development bonds under prior law, but there is no indication in the Act that this is true. A clarification which conformed to the Blue Book would be a substantive, rather than a technical change. It is suggested that subparagraph (B) of section 144(c)(2) of the 1986 Code be amended to read as follows:

> (B) the payment of the principal and interest on such issue is primarily secured by taxes of general applicability, or an increment thereof, imposed by a general purpose governmental unit,

Application of Maturity Limit to Qualified 501(c)(3) Bonds for Working Capital. Qualified 501(c)(3) bonds may be issued for the financing of purposes other than facilities. For example, qualified 501(c)(3) bonds may be issued for financing of working capital or refunding of prior debt. In such event the maturity limitation is inapplicable, by its terms. It is suggested that the original intent of Congress be clarified by amending section 147(h)(2) of the 1986 Code by adding a new sentence at the end thereat to read as follows:

> 'Subsection (b) shall apply to qualified 501(c)(3) bonds only with respect to facilities financed with such bonds.'

Application of Expenditure Exception to Rebate Requirement. Under present law, rebate requirements do not apply if gross proceeds of an issue are expended for the governmental purpose of the issue within 6 months of issuance. Most issues, however, provide for the funding of a reasonably required reserve fund in addition to funding for the primary governmental purpose of the issue. Reserve funds are retained to assure that a source of payment of the issue is available in the event of a temporary insufficiency of other sources of payment of debt service. It is suggested that the expenditure exception to the rebate requirement be amended to provide that a reserve fund need not be expended in order for the 6 months expenditure exception to apply.

It is also suggested that the expenditure exception be amended to to provide that the use of proceeds of an issue for redemption of the issue be treated as an expenditure for the governmental purpose of the issue on the date upon which such redemption is made.

In certain cases, the issuer may fully intend on the date of bond issuance to expend the proceeds of the bonds within six months thereof, but for reasons beyond the control of the issuer or for inadvertence, the issuer is unable to expend such proceeds. The suggested amendment would enable an issuer to cure the problem and thus to avoid rebate procedures by using the amounts which were not expended for redemption of the bonds. The Federal Government will thereby derive more revenue from the elimination of outstanding tax-exempt bonds than it would from the rebate of "excess" investment earnings.

Change in Use for Single Family Housing Bonds. Footnote 196 on page 1221 of the Blue Book indicates that, with respect to the change in use provisions contained in section 150(b)(1) of the 1986 Code for qualified mortgage bonds, Congress intended that the disallowance of interest deductions for bond-financed housing cease prospectively if the residence again qualifies as the mortgagor's principal residence. The footnote indicates, "A technical amendment may be necessary for the statute to reflect this intent." Such technical amendment should be made by the Bill.

Definition of "Proceeds". The term "proceeds" is used in a number of the provisions contained in sections 141 through 150 of the 1986 Code. Staff has indicated that the term "proceeds" means an amount equal to the reoffering price of the bonds to the public, that is, an amount equal to the price at which a substantial amount of the bonds of each maturity were sold to the public. Generally, this amount is equal to the face amount of the bonds, plus accrued interest on the bonds, plus original issue premium, less original issue discount. The term should be defined in the Bill.

Retroactive Designation of Bonds as Qualified Bonds for Purposes of Bank Deductibility Provisions. Section 109(b)(3) of the Bill provides that issuers may retroactively designate their bonds as bank qualified under the $10 million exception if certain conditions are met. For bonds issued after August 7, 1986 and before January 1, 1987, the issuer has until January 1, 1988 to make the designation. However, for bonds issued between January 1, 1986 and August 7, 1986, an additional requirement is added that the issue must have made a designation at the time of issue that it intended to qualify under section 802(e)(3) of H.R. 3838.

There is no persuasive reason for this additional requirement for bonds issued on or before August 7, 1986. Many small issuers did not make designations during such time period simply because the House Bill was pending and not yet law. Other small issuers thought they were protected by the March 14, 1986 Joint Statement and essentially ignored H.R. 3838. These issuers are now being asked to designate their bonds as bank qualified by investment bankers.

It is suggested that all bonds issued in 1986 may be retroactively designated as bank qualified until January 1, 1988.

Comments Of The
National Council of Farmer Cooperatives

Submitted To The
Taxation And Debt Management
Subcommittee Of The
Senate Finance Committee

Regarding

The Technical Corrections Act Of 1987
(S. 1350)
July 22, 1987

The National Council of Farmer Cooperatives (NCFC) fully endorses the comments of the Farm Credit Council regarding the restoration of the reserve method of calculating loan losses to Production Credit Associations (PCA) and Banks for Cooperatives (BC).

NCFC is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes 90 major marketing and farm supply cooperatives, the 37 banks of the cooperative Farm Credit System, and 33 state councils of farmer cocperatives. National Council members handle practically every type of agricultural commodity produced in the U.S., market these domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. Five out of six U.S. farmers are affiliated with one or more cooperatives. The National Council represents about 90 percent of the 5,600 local farmer cooperatives in the nation, with a combined membership of nearly 2 million farmers.

Farmer cooperatives and their members rely on the banks of the Farm Credit System to provide reliable credit at competitive interest rates. The Tax Reform Act added approximately $85 million in tax liability to the system over the next four years. Of that amount, $54.5 million will come from the BC's.

In order to meet this increased tax burden, BCs and PCAs will be forced to draw on capital reserves and/or increase interest rates. Either option threatens the financial health of an already distressed Farm Credit System by exacerbating borrower flight and devaluing borrower stock held by cooperatives and farmers. Because of the cooperative nature of the Farm Credit System, the impact of the tax change will be felt throughout agriculture.

At a time when Congress is working to provide financial assistance to the Farm Credit System, it seems unwise to further burden the PCAs and BCs with additional taxes.

NCFC respectfully urges Congress to restore the reserve method of calculating loan losses to PCAs and BCs as stated in the comments of the Farm Credit Council.

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JOHN L. SACHS JANNE G. GALLAGHER

July 23, 1987

Laura Wilcox
Mary McAuliffe
Committee on Finance
United States Senate
205 Dirksen Building
Washington, DC 20510

Dear Ms. Wilcox and Ms. McAuliffe:

On behalf of the National Independent Energy Producers Hydroelectric Tax Reform Committee, I am submitting a memorandum in support of a request for an amendment to the Technical Corrections legislation now being considered by the Senate Finance Committee. Also attached are proposed amendment language and a revenue estimate. This amendment would substitute for the placed-in-service date of the Energy Tax Credit for small hydros the startup date required in FERC licenses for qualifying hydro projects.

We have discussed this amendment with Janet Pollan.

Sincerely,

Harrison Wellford
Dawson Mathis

Enclosures

What no one anticipated in 1979 was the long bureaucratic delays at FERC in processing permit and license applications for these projects. Major legislative and regulatory changes since 1979 have greatly lengthened the approval period.

A review of license applications since 1980 shows that it usually takes between three and six years for the typical project to be licensed by FERC and several years longer for many other projects. Both Congress and FERC have changed the rules of the game during this eight-year period, adding months and sometimes years to the regulatory clearance process. In 1985, FERC promulgated pre-consultation regulations which required notification and often negotiation with more than 10 Federal and state agencies before an application could be filed with FERC. The requirement of "cumulative impact assessments" on selected river systems froze any action on projects for months at a time. Passage of the Electric Consumers Protection Act in 1986 added more regulatory hurdles for all pending projects. Extensive new rounds of consultation with environmental agencies were required, even where these agencies had already signed off on the projects.

As a result, the length of time needed for preparing a license application, the time required for FERC to act on it, and the time required for a developer to implement it have all increased substantially over the last eight years.

The cumulative effect of all these delays means that it takes far longer to bring a project on-line than originally estimated. It now appears highly likely that many worthwhile projects, despite the best efforts of their developers, will not be able to meet the December 31, 1988, dead-

JUSTIFICATION FOR CHANGING THE PLACED-IN-SERVICE DATE FOR SMALL HYDRO PROJECTS WHICH QUALIFIED FOR THE ENERGY TAX CREDIT ON 12-31-85

A number of small scale hydro projects (projects less than 80 MW) which have been under development for several years may lose their right to receive the Energy Tax Credit because of an arbitrary deadline established by Congress 8 years ago. When Congress passed the Energy Tax Credit in 1979 for qualifying small hydro projects, its goal was to encourage the development of clean, renewable, domestic sources of electrical energy which would reduce our dependence on foreign oil. Because of a strong response from small power producers willing to put private capital at risk, this goal has been largely realized. More than 1,000 MWs of clean, renewable hydropower have come on-line or been approved for development by FERC since 1980.

Under the 1979 Energy Tax Act, projects which had permit or license applications pending at the Federal Energy Regulatory Commission ("FERC") on 12/31/85 would qualify for the ETC if their facilities would be placed-in-service by December 31, 1988 -- three years later. This three-year period was set by Congress 8 years ago before developers had any experience in getting projects through the regulatory maze at FERC (PURPA, which provided a market for these projects, had passed only the year before, in 1978). There is nothing in the legislative history which explains why Congress chose this length of time. The only occasion on which Congress specifically considered the length of time required to complete a hydro project -- during amendments to the Federal Power Act -- it allowed a period of four to six years for licensed projects to complete construction.

line because of regulatory delays beyond their control. Given the current difficult financial circumstances of the small hydro industry buffeted by low energy prices, loss of the ETC may cause many projects to fail.

The arbitrary nature of the three-year "placed-in-service" deadline in the Energy Tax Act is highlighted by the fact that Congress, in passing the Federal Power Act and FERC in implementing the Act, assumed that at least four years and probably six years would elapse between the issuance of a license and bringing the licensed project on-line. Section 13 of the FPA provides for a two-year period between issuance of a license and commencement of construction and allows for a one-time two-year extension which is routinely granted by FERC; in addition, the FERC license normally gives developers two years after commencement of construction to place the facility in service. Extensions of this two-year period may be granted in special cases.

Compare this system with the three-year placed-in-service date required of projects qualifying for the ETC. Given the realities of the current regulatory process, only projects with licenses issued by 1985 had any chance of meeting the December 31, 1988, placed-in-service deadline. Even those licensed projects would have to accomplish in three years what the Federal Power Act routinely allows four to six years to complete. Projects with permit or license applications pending on 12/31/85 will have virtually no chance at all to meet this unrealistic deadline. If Congress intended that only licensed projects would receive the benefit of the ETC after December 31, 1985, it presumably would have said so.

Placed-in-service dates are designed to keep transitioned projects from having an open-ended claim on the

Treasury. They are a necessary and appropriate part of prudent tax legislation. They are designed to prevent developers from "inventoring" tax benefits on stale projects. But placed-in-service dates should not be set in such an arbitrary fashion that they defeat the purpose of the underlying legislation.

In this case, the requirement of a placed-in-service date in the ETC legislation was unnecessary. FERC sets a deadline for project completion in every license issued on a small hydro project. Projects which fail to meet this deadline may have their licenses revoked. Since the FERC controls the pace of the regulatory approval process, it makes sense that FERC should have the final say about when a project should be required to begin operation.

We propose that Congress replace the December 31, 1988, deadline with the placed-in-service date established by FERC in the license issued for the project. Nothing in the legislative history indicates that Congress intended that the placed-in-service date enacted by Congress in 1979 would snuff out viable projects on the threshold of completion. As this amendment will not change the 12/31/85 filing deadline, it will not add to the number of projects eligible for the ETC.

The costs of the Energy Tax Credit were funded with monies obtained from the Windfall Profits Tax legislation of 1980. Revenue estimates were made in 1979 of the cost of all the various business energy tax credits. Congress anticipated that the hydro energy tax credits would cost $1.8 Billion over 10 years. Even assuming that all the projects issued licenses by FERC from 1980-86 were built and claimed the credit, the costs in this time period were less than 1/4 of what Congress anticipated. ($132 million versus $567 million) As clearly not all projects receiving licenses were actually built, this estimate greatly understates the difference between Congressional estimates and what was actually claimed. If the 1988 placed-in-service date were replaced with the date set by FERC in a license, an additional $38,000,000 would be claimed. Combined with the ETC claims anticipated through 1988, this means the total credits claimed over the life of the ETC would be $190 million versus the $1.8 billion planned in 1979 - approximately 1/10 of what was anticipated.

Based on the 1980 Congressional revenue estimates, we assume that Congress expected to pay for the ETC of all projects qualifying at the end of 1985. In fact, many projects which qualified for the ETC at the end of 1985 have been terminated due to increased licensing requirements in the 1986 Electric Consumers Protection Act. Therefore even fewer projects will apply for the ETC than anticipated. For these reasons, we believe our proposal is essentially revenue neutral.

In last years Tax Reform bill, Congress extended the Energy Tax Credits for commerical applications of several renewable energy technologies such as solar, geothermal and biomass. Language related to small scale hydro's energy tax credits was not considered at that time. In order that the companies developing small scale hydro can make decisions on whether or not to continue investing in these projects, it is important to deal with this problem in this years Technical Corrections bill.

As the recent data on the increasing cost of oil imports and its effect on our balance of payments indicates, it is still vital to continue to encourage the development of domestic renewable energy sources. We urge your support of this techical amendment so that small scale hydro development can realize its full potential.

Proposed Statutory Language

Section 46(a)(2)(C)(iv) of Title 26 of the Internal Revenue Code should be amended by striking "December 31, 1988" and inserting in lieu thereof: "the placed in service date required by the Federal Energy Regulatory Commission in the project license."

July 14, 1987

Summary of the Effect on Tax Revenue due to the Energy Tax Credits If Placed-In-Service Date Is Set by FERC

The data below shows the estimated revenue loss to the U.S. Treasury for various placed in service dates. These numbers were obtained using the following approach:

1. The total megawatts eligible for ETC under each of the two placed in service deadlines were multiplied by $1.2 million to determine the estimated value of the project.

2. Using the appropriate ETC tax rates* for 1987 and 1988 and assuming that the 1988 rate would be continued for any extension, the Energy Tax Credits were calculated by multiplying the rate times the value from #1.

3. Because taking the ETC will reduce the depreciable basis of a project, the actual cost of the ETC to the Treasury will be reduced due to the lower depreciation deductions. The Effect on Depreciation figures were calculated by taking the value of the ETC x each of the the five year ACRS percentages** x 34% corporate tax rate and

totaling these five numbers. (The use of the 5 year ACRS rates assumes only transitioned property will be eligible for the ETC) This number shows what the depreciable value of the ETC would be.

4. The Loss to Treasury was calculated by subtracting the Effect on Depreciation values from the ETC values.

	TABLE 1 FERC Sets Placed-In-Service Date (Includes 1988 projects)	TABLE 2 Projects Placed In-Service by 1988	TABLE 3 Projects Placed In-Service Post 1988
# OF PROJECTS/MW	237 / 656MW	107 / 158MW	130 / 500MW
ETC VALUE	$53,031,000.	$15,451,000.	$37,580,000.
DEPRECIATION EFFECT	$18,030,000.	$ 5,253,000.	$12,777,000.
TOTAL REVENUE LOSS	$35,001,000.	$10,198,000.	$24,803,000.

The three tables summarizing how we determined the number of projects eligible for the Energy Tax Credits for the different placed in service dates are attached as well as the assumptions made in these calculations.

When the Energy Tax Credits were established in 1979, revenue estimates were made by Congress on the loss to the Treasury. The figures below compare the credits claimed to date and what may be claimed in the future versus what the Congress estimated would be claimed.

It should be noted that the estimate of what has been claimed from 1980 through 1986 is based on data from FERC on the number of licenses issued during this time period. This estimate is probably much higher than the actual amount claimed because not all projects issued a license are built and the number below includes municipal projects, most of which are not eligible for the ETC.

	Congressional Estimate of ETC Claims	Estimated ETC Claims from Projects Issued Licenses
1980 - 1986	$567,000,000	$ 132,132,000
1987	$427,000,000	$ 8,930,000
1988	$582,000,000	$ 6,521,000
1989	$137,000,000	$ 12,184,000
1990	$ 84,000,000	$ 16,474,000
1990-1994	not estimated	$ 14,071,000
TOTAL	**$1,797,000,000**	**$ 190,312,000**

* ETC Rates:
1986 - 11%
1987 - 9.075%
1988 - 7.15%

** 5 Year ACRS Rules
Year 1 - 15%
Year 2 - 22%
Year 3 - 21%
Year 4 - 21%
Year 5 - 21%

Table 7.—Estimated Budget Effect of Business Energy Tax Incentives as Agreed to by the Conference Committee, Calendar Years 1980–85

Provision	1980	1981	1982	1983	1984	1985
Business energy investment credits:						
Solar and wind property including solar process heat equipment, 15% energy credit	−10	−19	−34	−108	−282	−497
Geothermal equipment, 15% energy credit	−1	−2	−2	−5	−8	−11
Ocean thermal energy conversion equipment, 15% energy credit	([2])	([2])	([2])	([2])	−2	−2
Small-scale hydroelectric facilities, 11% energy credit	−7	−13	−17	−21	−81	−144
Cogeneration equipment, 10% energy credit	−31	−53	−78	−82	−65	−36
Petroleum coke and pitch, regular investment credit and accelerated depreciation	−25	−30	−34	−38	−43	−47
Certain equipment for producing feedstocks			([1])	−22	−29	−28
Alumina electrolytic cells, 10% energy credit	−1	−1	−1	−1	−1	−1
Coke ovens, 10% energy credit	−37	−46	−56	−59	−45	−23
Biomass equipment, 10% energy credit	([2])	−4	−4	−18	−160	−352
Intercity buses, 10% energy credit	−5	−5	−6	−6	−7	−7
Affirmative commitments, special transition rule			([1])	−448	−358	−202
Total, energy investment credits	**−117**	**−173**	**−232**	**−808**	**−1,081**	**−1,350**

Table 7.—Estimated Budget Effect of Business Energy Tax Incentives as Agreed to by the Conference Committee, Calendar Years 1986–90—Continued

Provision	1986	1987	1988	1989	1990	1980–90
Business energy investment credits:						
Solar and wind property, including solar process heat equipment, 15% energy credit	−78	−30	([1])			−1,058
Geothermal equipment, 15% energy credit	([1])					−29
Ocean thermal energy conversion equipment, 15% energy credit	−1					−5
Small-scale hydroelectric facilities, 11% energy credit	−284	−427	−582	−137	−84	−1,797
Cogeneration equipment, 10% energy credit	−11	([1])				−356
Petroleum coke and pitch, regular investment credit and accelerated depreciation	−52	−58	−63	−68	−74	−532
Certain equipment for producing feedstocks	−22	−9	([2])			−110
Alumina electrolytic cells, 10% energy credit						−12 [3]
Coke ovens, 10% energy credit	−7	−3	−1			−277
Biomass equipment, 10% energy credit	−55	−32	−23	([1])		−648
Intercity buses, 10% energy credit						−36
Affirmative commitments, special transition rule	−90	−42	−12	([1])	([2])	−1,152
Total, energy investment credits	−600	−601	−681	−205	−158	−6,012 [3]

July 10, 1987

The Honorable Lloyd Bentsen
Chairman
Senate Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the National Leased Housing Association, which represents state and local housing agencies, developers, and equity investors of low-income housing, and the Council for Rural Housing and Development, which represents developers and equity investors involved in the Farmers Home Administration Section 515 rural housing program, we would like to briefly comment on an aspect of the Technical Corrections Act of 1987, S. 1350.

Our comment relates to Section 105 (b)(2) of the Act, pertaining to the transitional rule for certain low income housing projects. We are very pleased with the insertion of this transitional rule in the Technical Corrections Act and very much appreciate the efforts that you made during the debate over the technical corrections resolution that was introduced in the last session of Congress. Our comment on this provision is a highly technical "fine-tuning" one, and should not be interpreted as diminishing the importance of including this rule in the bill.

Under the "Special Rule for Certain Partnerships" as provided in Section 105 (b)(2), a partnership could qualify for transitional relief if, among other things, it placed a property in service on or after December 31 and before August 17, 1986, continuously held such property and, in addition, the partnership was not treated as a new partnership or as terminated at any time on or after December 31, 1985. A problem is created, which we believe was unintentional, for some properties which may have been placed in service during this eight month period, if the partnership placing that property in service was formed any time after December 31, 1985. For example, an otherwise qualified property might have been placed in service on April 1, 1986 and the partnership formed on March 1, 1986. Under the wording of the bill, such a partnership would not qualify, even if it continuously held the property on and after April 1, 1986.

The drafters clearly intended that there be a prohibition on a partnership selling a property or being formed after such a property was placed in service and we understand the policy reasons for that provision. However, in order to accomplish this goal, the partnership formation or termination date should be tied to the placement in service date of the property, not the date December 31, 1985. This formulation would, in our judgment, satisfy the Congressional concern that there be no sales of properties after they have been placed in service if relief were sought under the transition rule. However, it would do so in a manner that would not inadvertantly penalize partnerships which happened to have been formed after December 31, 1985 but before a project was placed in service during this eight month "window period".

Thus, we would ask that the language contained on line 22 of the bill be amended by striking out "December 31, 1985" and inserting in lieu thereof, "the date which the partnership placed such property in service".

We would very much appreciate your consideration of these comments, and the inclusion at the Committee's markup of the amendment which is noted above. Thank you very much.

Very truly yours,

COUNCIL FOR RURAL HOUSING AND DEVELOPMENT

NATIONAL LEASED HOUSING ASSOCIATION

National Presto Industries, Inc.
Eau Claire, Wisconsin 54703

JOSEPH H. BERNEY
VICE CHAIRMAN

July 16, 1987

U.S. Senate Committee on Finance
Senate Dirksen Office Building
Constitution Avenue and First Street, N.E.
Washington, D.C. 20510

Re: Comment - Technical Corrections Act of 1987
(S. 1350)

Dear Members:

It is obvious from the text of the Technical Corrections Act of 1987 that the Act provides an excellent means of simplifying the tax code by clearing out provisions in the law which have become redundant or unnecessary by virtue of the enactment of the Tax Reform Act of 1986. Section 106(e)(9), (10) and (11) of the Technical Corrections Act is an excellent example of the use of the Technical Corrections Act to eliminate provisions of the Code that have become unnecessary by virtue of the Tax Reform Act. In what strikes me as an excellent job by the Committee staff, the incredibly complicated provisions of Section 301 of the Code have been streamlined and many of that Section's portions have been repealed as "deadwood".

Similarly, the Accumulated Earnings section of the Code should be modified in a similar manner. The Committee has provided in the Technical Corrections Act for a change in the tax rate on accumulated earnings to bring them in line with the individual rates. In conjunction with these technical changes, Congress should repeal Code Section 532(c) as "deadwood".

As you are aware, Code Section 532(c), added by Congress in 1984, made the accumulated earnings tax applicable, for the first time, to widely-held corporations. The legislative history shows that 532(c) was a reasonable Congressional response to the formation of investment corporations which were formed for no true business purpose, but were simply a device to take advantage of the difference between the capital gains tax rate and the dividend tax rate. The investment corporations used their capital to purchase dividend paying stocks of other corporations. The investment corporation, receiving a dividend, was subject only to the nominal tax on the dividend (an effective rate of 6.9%) and, instead of paying these dividends to its shareholders, it accumulated the dividends. The investment corporation's policy was to never pay dividends and accordingly its shares increased in value roughly equal to its dividend income. Shareholders thus paid no taxes on dividends of the underlying stocks held by the investment corporation but could realize income equivalent to the dividend accumulation by selling their shares. Of course, the gain on the sale of those shares was taxable as capital gains (20%) rather than ordinary dividend income (as high as 50%). The Congressional response to this tax avoidance scheme was the passage of Code Section 532(c) which, for the first time, applied the accumulated earnings tax to widely-held corporations. The potential levy of the accumulated earnings penalty rate made the investment corporation an uneconomical means of avoiding taxation and effectively ended these companies, thereby insuring that dividend income would be taxed at the shareholders level at ordinary income rates.

Under the Tax Reform Act of 1986, capital gains shall be taxed at the same rate as dividend income. Accordingly, the Act also insures that the investment corporation device, which converts dividend income into capital gains income, is uneconomical. In fact, under the Act, it would serve no purpose. Likewise, the Act insures that dividend income will be taxed at ordinary rates, for there will no longer be a difference between capital gains and dividend rates. Under these circumstances, Section 532(c) is superfluous and, like Section 301(e), should be repealed as "deadwood".

In addition to the fact that 532(c) is now "deadwood", it is still significant to note that it is not good public policy to apply the accumulated earnings tax to widely-held corporations. In a widely-held corporation, the payment of a dividend or the accumulation of funds for expansion, investment or research and development is a decision best left to a board of directors. However, as a result of the applicability of the accumulated earnings tax to widely-held corporations, there may be a tendency for corporations to pay dividends, even when the corporate resources should be husbanded for important future business expenditures. The ability of the Internal Revenue Service to second-guess the directors by applying the accumulated earnings tax to a widely-held corporation should not be the driving force behind a decision regarding dividend policy. Rather, the checks and balances of the marketplace should be allowed to have their natural and free effect on a widely-held corporation's board of directors. As such widely-held corporations are, by definition, publicly held by many shareholders, it is in the board's interest to make dividend decisions based on the marketplace and the corporation's business needs. The repeal of Section 532(c) will allow corporate directors to determine dividend policy without reference to an unnecessary and punitive application of the accumulated earnings tax.

I am taking the liberty of attaching to this letter a position paper previously provided to members of Congress regarding this issue. I appreciate your attention to these comments and would be happy to meet with you or any members of the staff to discuss these issues.

Best regards,

NATIONAL PRESTO INDUSTRIES, INC.

Joseph H. Berney
Vice Chairman

PROPOSED TECHNICAL CORRECTION TO THE TAX REFORM ACT OF 1986

SECTION 532(c) SHOULD BE REPEALED

I. BACKGROUND

The Tax Reform Act of 1986 is an extremely complex piece of legislation. Moreover, it made sweeping changes to what was an already highly complicated area of the law in a piecemeal fashion -- through amendments rather than by creating an entire new tax code. Under these circumstances one would expect numerous errors of a technical nature due to failures to determine all of the possible ramifications from any one change. That there are so few such oversights, is a tribute to the brilliant execution of the task by Congress and its staffs and is nothing short of remarkable. Nevertheless, there were inadvertent oversights which do require correction. One such oversight was the failure to repeal Section 532(c) to make the accumulated earnings tax law consistent with the alterations the reforms made to the capital gains tax, the corporate income tax, and individual income tax rates.

II. HISTORY OF SECTION 532(c)

The accumulated earnings tax is imposed upon corporations that accumulate earnings and profits (rather than paying them out as dividends) to assist their shareholders in avoiding income taxes. Historically, the tax had not been applied to widely-held corporations. By its very nature, a widely-held corporation does not lend itself to the requisite conspiracy between management and shareholders for tax avoidance. As it is widely-held, there are typically shareholders to whom payment of a dividend is critical (for example, pension funds which have become one of the dominant forces in the stock market owning approximately 40% of publicly traded shares). If the corporate directors wish to retain their positions, they must consider these shareholders who have the power to vote them out directly on an annual basis or to sell their shares (leaving the company vulnerable to a takeover if the stock value drops too far and as a direct result, the directors without their jobs). Unless the corporation is in a true expansionary mode or on the threshhold of such an expansion (in which case the shareholders will be patient about no or low dividends as better prospects are on the horizon), it is definitely in the interest of the directors to pay out dividends simply to retain their positions. Nor is it good public policy to apply the accumulated earnings tax to widely-held corporations. Such application tends to cause dividend pay outs where they are not in the best interest of the shareholders due to fear that the highly punitive accumulated earnings tax (a nondeductible tax of 27 1/2% on the first $100,000 of accumulated earnings and 38 1/2% thereafter) will be imposed by an aggressive Internal Revenue agent. The payment of dividends is best left to the duly elected board of directors. The appropriation and dedication of corporate funds, which are the lifeblood of a corporation, is the most important function of the board of directors. Certainly, it should not be determined by legislative fiat.

Unfortunately, the atypical conspiracy situation between management and shareholders of a widely-held corporation did come into being. It was only possible as a result of the differences between the capital gains tax rate (20%) and the dividend tax rate (for high bracketed individuals as high as 50%). Investment corporations were formed which carried on no true business, but were simply a device to take advantage of the difference between the two rates. Such corporations used their capital to purchase dividend paying stock of other corporations. A corporation which receives a dividend from another corporation is subject to only a nominal tax on the dividend, as it is assumed that the dividend will in due time be disbursed to an individual shareholder of the receiving corporation, who will then pay the normal dividend tax. Dividends should not be subject to tax more than once. The specially formed investment corporations, however, as a stated policy, paid no dividends. Instead they accumulated the dividends they received and used them to purchase additional dividend paying stock. The result was an increase in the price of the shares of such investment corporations roughly equal to the dividends they were receiving, due to the fact that the shares were attractive to individuals who wished to avoid the tax on dividends. The individuals would then sell the shares, realize the "dividend" gain, and pay a lower tax (20% vs. 50%) than the individual would otherwise have paid on the dividends. Literally, a widely-held corporation had been created which was in the sole business of accumulating earnings (dividends from other corporations) for tax avoidance purposes (to permit its shareholders to convert income otherwise taxable at ordinary rates into capital gains).

Congress put an end to such corporations in 1984 by adding section 532(c) to the law, which made the accumulated earnings tax applicable for the first time to widely-held corporations.

III. RATIONALE FOR THE TECHNICAL CORRECTION

Once the transition period is over, as a result of the Tax Reform Act of 1986, individual tax rates will be less than corporate tax rates and the capital gains rate will be equal to the dividend rate. This sweeping change to rates impacted more than the sections concerning rates. To the extent Congress did not modify these other sections to make them consistent with the effect of the rate changes, it should do so now through the Technical Corrections Act of 1987.

One such area is Section 532(c), a 1984 amendment intended to prevent the conversion, through the device of a widely-held public corporation, of dividend income into income taxed at the lower capital gains rates. As capital gains will be taxed at the same rate as dividend income, at the end of the transition period, this section will soon be superfluous. With the change in tax rates, it is also potentially damaging to corporate America. Once the transition period is over, the accumulated earnings tax will be the highest tax in existence -- 38 1/2% versus the top individual bracket of 28% and the top corporate tax of 34%. That provides an enormously powerful incentive to an aggressive Internal Revenue Service agent to second guess a management-shareholder decision to not pay or to pay "low" dividends. The tendency will be to pay dividends, even when resources should be husbanded, for example, for expansions which from a timing point of view should not be made immediately for a variety of reasons (the staff required to properly implement the expansion needs to be hired and trained, the product to be produced requires the successful marketing of a complementary product (e.g., before film for the polaroid camera could be sold, the polaroid camera itself had to be marketed) etc.), which ultimately will be overcome. It is dangerous indeed with the burden of proof on the corporation, to dispute with the Internal Revenue Service whether the decision not to pay out or to pay "low" dividends was tax motivated or whether the reason for retaining capital was done for sound business reasons. With the checks and balances in place through the market system, it is counterproductive to place the determination of the validity of business actions in the hands of the Internal Revenue Service and the courts. Counterproductive, not only to the businesses themselves, but likewise to the U.S. government in terms of the healthy tax base which results from business expansion. The immediate benefits from taxes on current excessive dividend pay outs should not be allowed to outweigh the long term ongoing advantages of an expanding tax base upon which our economy and government will ultimately depend.

IV. RECOMMENDED ACTION

To make Section 532(c) consistent with the changes made to capital gains, individual, and corporate rates, the section should be repealed.

Conservative Baptist
National Stewardship Ministries

Harry D. Pittman
National Representative
2535 E. Cactus Rd.
Phoenix, Az. 85032
602-971-6188
602-992-[redacted]
2022

July 2, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

RE: IRC Sec. 501(m) - Technical Corrections Act of 1987 (H.R. 2636) Charitable Gift Annuities

Dear Ms. Wilcox:

I am writing to you on behalf of our 2,000 churches and over 500,000 constituency in the United States, plus our approximately 2,200 churches and alike constituency outside of the United States regarding the Technical Corrections Act of 1987 (H.R. 2636) requesting that you please support an amendment to the Technical Corrections Act to clarify the position of Charitable Gift Annuities issued by IRC Sec. 501(c)(3) organizations that such Charitable Gift Annuities are not "commercial-type insurance" under IRC Sec. 501(m).

As you are aware, many charitable organizations, but especially church denominations, use Gift Annuities because an interested donor wants to make a gift to help our ministry efforts. They are not making the investment in the annuity in order to receive an insurance benefit. Charitable Gift Annuities have been used by church organizations, as well as many other charitable institutions for well over one hundred years. There is a long precedent in our nation's history and tax-law in support of the Charitable Gift Annuity as a charitable gift and not as "commercial-type insurance."

Secondly, Charitable Gift Annuities do not compete with commerical annuities since it costs the donor more to invest in a gift annuity than it does in a commercial annuity, and therefore Charitable Gift Annuities are not "commercial-type insurance."

Thirdly, continuing to classify Charitable Gift Annuities as "commercial-type insurance" fails to clarify the law so that this important source of funds for our denomination's charitable activities would tend to dry up.

Finally, for our small donors, a Charitable Gift Annuity has the same result for them that larger donors' investments in a Charitable Remainder Annuity Trust has for them. As you know, the Charitable Remainder Annuity Trust is unaffected by IRC Sec. 501(m). I trust you will use the weight of your office to see that as the Technical Corrections Act makes it way through the House and Senate Committees and onto the Floor of the respective Houses, we can remove Charitable Gift Annuities from being classified as "commercial-type insurance."

I thank you in advance for your respectful and kind attention to this matter and plead the cause of our denomination in your help in making this correction.

Respectfully,

Harry D. Pittman, Director
Stewardship Ministries

HDP:vl Conservative Baptist Association of America P.O. Box 66, Wheaton, Illinois 60187

OF AMERICA

NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

COMMENTS ON H.R. 2636

THE TECHNICAL CORRECTIONS ACT OF 1987

The National Telephone Cooperative Association (NTCA) is a national trade association dedicated entirely to representing and serving the interests of the nation's rural independent telephone systems.

A non-pofit trade association, NTCA today represents more than 450 small, independent cooperative and commercial telephone companies located in 42 states. More than five million consumers get their telephone service from NTCA members systems.

NTCA respectfully requests that the Technical Corrections Act of 1987 be amended so non-exempt rural telephone cooperatives are allowed to treat patronage dividend allocations as a reduction in determining net book income and so tax-exempt telephone cooperatives are allowed to offer 401(k) retirement plans to their employees.

Background on Rural Telephone Cooperatives

Congress amended the Rural Electrification Act in 1949 with the goal of providing affordable telephone service throughout the country. Most telephone cooperatives began in the 1950's with little equity and were boot-strap organizations with the goal of achieving self-sufficiency. Because the cost of providing telephone service to low density rural areas was not economically attractive, most large telephone companies could not - or would not - provide service to these areas. With financial assistance from REA, cooperatives were formed throughout the country to provide telephone service primarily in sparsely populated rural areas.

Telephone cooperatives had two important means to generate the necessary financing to assist them in providing telephone service. First, cooperatives are able to secure equity capital from their members. Second, there was the REA loan program. Generally, cooperatives have retained the equity capital and then paid it back to subscribers in the form of patronage dividends when financial conditions warrant. Unlike regular corporate profits, the amount above the operating costs of the cooperative are not profits or earnings but are capital contributed by the members and therefore not taxable.

Problems faced by rural telephone cooperatives continue today and, in some ways, are more difficult than ever:

Low Density - REA borrowers serve rural areas that have an average of only five customers per mile of telephone line, while the Bell Operating Companies have approximately 130 customers per square mile, and all telephone companies average 50 customers per mile.

Financing - Telephone cooperatives have traditionally received most of their financing from REA loans. While the expense of providing telephone service to rural areas remains high, REA financing may become difficult to obtain. The REA loan levels have been frozen for the last ten years and the program itself has been targeted for elimination by this Administration. It is difficult for telephone cooperatives to obtain long term financing from commercial lenders. Today the average equity of REA cooperatives is 30%, well below the 40% to 60% debt-equity ratio required by commercial lenders.

Deregulation - Deregulation of the telephone industry has brought about several major policy shifts which could reverse or diminish historical revenue and income growth trends. The phase-out of settlements among states, competition for service to selected customers and the shift in allocation and recovery of costs could provide less revenue for local telephone companies.

In the competitive, deregulated environment, local telephone companies are asked to provide more sophisticated services. For example, technological advancements have created the need for digital switching to provide equal access to alternative long distance carriers and to provide many of the new custom calling services sought by subscribers. Underground cable provides more reliable, higher quality transmission and is needed to reduce maintenance and frequent outages caused by the harsh weather conditions in many rural areas.

With the help of the REA telephone loan programs, rural telcos are able to replace obsolete equipment in order to provide better services to their customers.

Taxation of Cooperatives

Most cooperatives are qualified for tax-exemption under Section 501(c)(12) of the Internal Revenue Code. This section states that a cooperative that provides telephone service to rural areas is tax-exempt only if 85% or more its income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

If the telephone cooperative cannot meet this requirement, it loses its tax exempt status under Section 501(c)(12). The non-exempt cooperative would be taxed on revenues received as interest or rental income or gains on the disposition of a capital asset as well as any revenue not received from its patrons.

If a telephone cooperative is non-exempt from income tax under Section 501(c)(12), it is subject to the same treatment as any other taxpayer with respect to computation of taxable income, with one important exception: a cooperative may exclude allocations of patronage credits if it meets all of the following requirements for non-profit operations as set forth in Farmers Cooperative Co. v. Birmingham, 33 TC 266 (1959):

. . .

> ...an allocation of earnings by a cooperative to its patrons cannot qualify as a true patronage dividend unless:
>
> (1) the allocation was made pursuant to a legal obligation which existed at the time the participating patrons transacted their business with the cooperative;
>
> (2) the allocation was made out of profits or income realized from transactions with the particular patrons for whose benefit the allocation was made; and,
>
> (3) the allocation of earnings was made ratably to the particular patrons whose patronage created the income from which the allocated refund was made.

IRC Section 552, which was repealed by Subchapter T, allowed exempt farmer cooperatives ~~to~~ deduct or exclude the face value of credits allocated to patrons. Subchapter T specifically changed this for farmer cooperatives who were subject to its rules but excluded telephone cooperatives. Senate and House reports on the adoption of Subchapter T state that Subchapter T also does not apply to cooperative organizations "which are engaged in furnishing electric energy, or providing telephone service to persons in rural areas. These will continue to be treated the same as under present law." Sen. Rep. No. 87-1881; 1962-3 C.B. 707, 819, House Rep. No. 87-1447; 1962-3 C.B. 405, 483.

No other provision dealt with the deduction of patronage credits by cooperatives. But, longstanding administrative policies, court cases and revenue rulings stated that before enactment of Subchapter T cash and non-cash patronage credits paid or allocated under a pre-existing obligation were deductible by cooperatives, regardless of whether they were includable in income by the patrons. See, Farmers Cooperative Company v Commissioner, 228 F 2d 315 (8th Cir. 1961).

The court decisions justify exclusion of patronage dividend (or credits) on the basis that:

a. The cooperative is a mere agent for the patrons and serves only as a conduit for the income of the patrons, or;

b. Patronage dividends represent a price adjustment in the cost of goods, analogous to discounts and rebates given by a seller at the time of sale or upon prompt payment.

Another legal basis for excluding patronage allocations is that the patron has received the money in the face amount and has reinvested the amount in the cooperative's capital pursuant to the by-laws or some other contract. (See Rev. Rul. 54-10; Rev. Rul. 55-56, 1955-1, CB 282; Rev. Rul. 57-59. Also "Model By-laws for Telephone Cooperatives," Section 1101 of REA Telephone Operations Manual).

A non-exempt telephone cooperative may exclude from taxable income all amounts of operating income received from patrons. This is allowable because, as mentioned above, there is a pre-existing mandatory obligation to return such amounts to the patrons or to account for the amounts as the property of the patrons.

Telephone cooperatives do not pay tax on their margins and patrons' capital, whether paid in dividends or allocated to patrons' capital accounts. This is essential to their ability to obtain the necessary capital to provide telephone service in rural areas. Tax-exempt treatment of patronage credits is a valuable supplement to whatever funding is obtained from REA.

Request for Technical Correction Relating to Alternative Minimum Tax

The alternative minimum tax subjects a portion of a non-exempt cooperative's patronage capital contributions to taxation through the book income adjustment provision. This is inconsistent with the legislative history and case history of the taxation of non-exempt rural telephone cooperatives. Taxation of capital credits would hinder cooperatives from attaining sound financial status at a time when they are striving for self-sufficiency. The result would be to increase the need for federally financed loans to provide telephone service to rural areas.

When an investor purchases stock in a company, he or she is not taxed nor is the company taxed on the capital. It is inappropriate to subject capital to income tax and therefore a cooperative's patronage capital contributions should not be taxed.

To subject a cooperative's patronage capital contributions to taxation would impede our country's goal of making affordable telephone service universally available to persons in rural areas with quality equal to that of urban telephone services. We have a national telecommunications system. If people in urban areas are to communicate with residents and businesses of rural areas, the quality of the system must be maintained.

NTCA requests that the Technical Corrections Act of 1987 include a provision allowing non-exempt telephone cooperatives to exclude patronage capital contributions when determining the cooperative's adjusted book income. Congress recognized the fact that a cooperative's patronage capital contributions should not be subject to the alternative minimum tax when it excluded farmers marketing cooperatives defined under Section 1381 of the IRC from including the patronage allocation in determining book income. NTCA requests that the following language amending Sec. 56(f)(2) of the IRC be included in the Technical Corrections Act of 1987:

> any corporation operating on a cooperative basis and and described in Section 1381(a)(2)(c) shall treat any allocation which is in the nature of a patronage dividend as a reduction in determining the corporation's net book income.

Request for Technical Correction Relating to 401(k) Retirement Plans for Employees of Rural Telephone Cooperatives

The Tax Reform Act of 1986 eliminated the ability of tax-exempt organizations to offer 401(k) retirement plans to their employees if they had not done so by July 2, 1986.

Congress recognized that rural cooperative utilities must compete with commercial companies for qualified employees with very specific, technological skills when they included a provision in the Tax Reform Act of 1986 which allowed rural electric cooperatives that are tax-exempt under Section 501(c)(12) of the IRC to continue to offer 401(k) plans to their employees. Rural telephone cooperatives are also defined under Section 501(c)(12).

Small rural telephone cooperatives must compete with much larger commercial companies for technically qualified staff. Under the tax code, commercial companies are able to offer a variety of profit-sharing and deferred compensation plans in addition to comparatively higher salaries. Like rural electric cooperatives, rural telephone coperatives are non-profit, tax exempt organizations and are unable to offer profit-sharing or stock option plans.

Rural telephone cooperatives must be able to offer complete compensation packages to attract qualified employees. One of the most popular savings programs for employees of telephone cooperatives has been the 401(k). Under Section 401(k) an employee may elect to defer a part of compensation and place the deferred amount in a section 401(k) plan set up by the employer. The deferred compensation is not subject to federal income tax until it is paid to the employee. The plan has allowed both management and rank-and-file employees to provide for their own retirement.

Based on the participation rate of telephone cooperative employees who are unable to take advantage of 401(k) plans, it is anticipated that 2300 people nationwide would be allowed to take advantage of 401(k) retirement savings plans. Because of the minimal number of persons affected by this amendment, it is anticipated that there will be negligible revenue impact.

NTCA requests that the Technical Corrections Act of 1987 reconcile the inadvertent omission of telephone cooperatives as relates to Section 401(k) of the IRC by the inclusion of the following language:

<u>SECTION 1. </u> RURAL TELEPHONE COOPERATIVES PERMITTED TO HAVE QUALIFIED CASH OR DEFERRED ARRANGEMENTS.

(a) IN GENERAL. -- Paragraphs (1) and (2) of section 401(k) of the Internal Revenue Code of 1986 (relating to cash or deferred arrangements) are each amended by striking out "or a rural electric cooperative plan" and inserting in lieu thereof "a rural cooperative plan."

(b) RURAL COOPERATIVE PLAN DEFINED. -- Paragraph (7) of section 401(k) of such Code is amended to read as follows:

"(7) RURAL COOPERATIVE PLAN. -- For purposes of subsection, the term 'rural cooperative plan' means any plan --

(a) which is a defined contribution plan (as defined in section 414 (i), and

(b) which is established and maintained by a rural electric cooperative (as defined in section 457(d)(9)(B), a cooperative telephone company described in section 501(c)(12) or a national association of such cooperatives."

COMMENTS OF THE

NATIONAL TOOLING AND MACHINING ASSOCIATION

REGARDING THE

TECHNICAL CORRECTIONS ACT OF 1987

(H.R.2636, S.1350)

The National Tooling and Machining Association supports the clarification that disallowed costs under expensing provisions (sec. 201(d) of the Reform Act and sec. 179 of the Code) may be carried forward an unlimited number of years.

We support the provision allowing 90 days after the enactment of this bill for stock options to be amended so that they may be treated as incentive stock options.

We suggest transition rules for the $25,000 active participation requirements for rental real estate activities and for the definition of "active participation." Taxpayers exceeding the $25,000 limitation are placed at an unfair disadvantage if they are penalized on one hand by the tax code if they do not come immediately into compliance and on the other by the marketplace if they dispose of property in an unfavorable market in order to bring themselves back under the $25,000 limitation.

We suggest that active participation rental real estate losses be limited to the greater of $25,000 or 90% of the prior year's active participation real estate losses, also with a three year phase-in.

While not a technical correction, we continue to believe that it is unfair to tax homeowners on amounts refinanced in excess of the original cost of the home. The provision effectively prevents any refinancing in many cases since points and other loan costs may be prohibitively high in comparison to the non-taxable equity in the home. We also suggest that the provision be changed to apply only to homes purchased after the enactment of the 1986 tax act.

We appreciate provisions overturning IRS Notice 87-8, which has blocked taxpayers from using income from installment sales entered into before 1987 to offset losses from passive activities.

We believe there should also be a transition rule for capital gains. Capital appreciation occurring before the enactment of the 1986 tax act should be taxed at a level commensurate with what the taxpayer's 1986 effective capital gains rate would have been upon disposition of the property, with the balance taxed under the new capital gains rate.

The elimination of personal interest deductions under the 1986 tax act unfairly penalizes taxpayers with existing financed personal debts prior to the enactment of the law and who were not in a position to repay those debts in full. As a transition rule, we suggest that interest deductions on personal debts incurred prior to the enactment of the proposal be grandfathered.

We believe the completed contract provisions (sec. 804 of the 1986 act) will impose undue accounting burdens on small firms. We suggest that small businesses, as defined by Small Business Administration size standards, be exempted from those provisions of the 1986 tax act.

We hope that the Committee finds these suggestions useful.

THE NAVIGATORS

Russell P. Reid

July 17, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox,

I have just learned that a change in the Technical Corrections Act could discourage the creation of future charitable lead trusts. It will hurt lead trusts by appealing the charitable deduction.

As you know, many donors with large estates arrange for the transfer of substantial assets to family members after the payment of income to charitable causes. Many organizations depend heavily upon this type of funding and its repeal could drastically reduce services that these charities provide.

I would encourage the committee to seriously consider the reduced income charities will have to serve our public and to restore these beneficial tax provisions.

Sincerely,

Russell P. Reid, CFP
Planned Giving Director

Post Office Box 6000, Colorado Springs, Colorado 80934, 303/598-1212

Linda L. Neff
P.O. Box 15307
Rio Rancho, NM 87124

(505) 892-5867

September 8, 1987

Dear Hearing Clerk,

The 1986 Tax Reform Act contains uniform capitalization rules which the IRS contends apply to self-employed, freelance authors. Because of the nature of the writing business, this could be devastating to those of us who are professional writers. Under the new rules, only the financially secure could continue to work.

I request that a clarification be made in the Technical Corrections Bill S1350, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules. Otherwise, to paraphrase Flannery O'connor; if we want to eat and write, we had better arrange to inherit money.

Sincerely,
Linda Neff

Karl B. Nelson
1520 West Beach Drive
Panama City, Florida 32401

July 31, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
U. S. Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

The Tax Reform Act of 1986 has a provision that results in less than currently prescribed lump-sum payments for many retirees who elected a lump-sum settlement during the years of 1985 and 1986.

The company I retired from did not pay lump-sum settlements according to the currently applicable Retirement Equity Act (REA) provisions. The REA, and the corresponding Internal Revenue Service regulations require that the Pension Benefit Guaranty Corporation (PBGC) interest rate or a rate lower be used in calculating lump-sum settlements. The company I retired from used an interest rate which was substantially higher resulting in a lump-sum payment that was much smaller than prescribed by law.

The Tax Reform Act of 1986 allows companies to use an interest rate no greater than 120% of the PBGC rate if the distributions from their plan were not made in accordance with the regulations issued under the Retirement Equity Act. This provision gives companies not in compliance with the Retirement Equity Act a 20% savings at the expense of the retirees.

This is not a fair and equitable provision. Please be aware that all settlements after 1986 will use the PBGC rate which is the same as the Retirement Equity Act.

I am for Tax Reform, however, the provision regarding lump-sum settlements (or cash-out of certain accrued benefits) has gotten a lot of companies "off the hook" at the expense of some retirees like myself.

I strongly request your aid and assistance in correcting this inequitable and discriminatory provision by using 100% of the PBGC rate in Title X1, Part 1V, Sec. 1139 in the Technical Corrections Bill now pending.

Sincerely,

Karl B. Nelson

Karl B. Nelson

KBN/sym

New England
Baptist
Hospital

91 Parker Hill Avenue
Boston, Massachusetts 02120

617 738-5800

Telex (23) 4430116
Cable NEBAPTHOSP BOSTON

July 20, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Re: Technical Corrections Act of 1987

Dear Ms. Wilcox:

I am writing to express my concern that charitable gift annuities not be subject to taxation under section 501(m) of the IRS code in the Tax Reform Act of 1986. **I urge the Senate Finance Committee to amend the Technical Corrections Act of 1987 and clarify that charitable gift annuities issued by 501(c)3 organizations are not commercial-type insurance.**

The primary motive of donors to our hospital who use the charitable gift annuity vehicle is to help the hospital, not to purchase insurance or receive an annuity. These donors are almost always senior citizens who have labored on the hospital's behalf through our Woman's Auxiliary or League for many years, and are on restricted incomes. They cannot afford a large gift to the hospital, but can afford a gift of several thousand dollars as long as they receive the security of some life-income in return.

With government cutbacks in funding, charitable gift annuities constitute an important remaining fund raising option for us, especially with our older constituents.

For the donor who cannot afford the size of a gift to fund a charitable remainder annuity trust [which is unaffected by Section 501 (m)], the loss of the charitable gift annuity option would deprive them of an important way of contributing to an institution they have supported for years with their hours of volunteer work and small cash gifts.

Because the charitable gift annuity is prevalent and popular among our senior citizens' peers, they understand it and like it. They may also have a similar plan with their local church, and have found it a practical way to give. In fact charitable gift annuities have been used in the non-profit community for over a century.

New England Baptist Hospital would be very grateful for your support and leadership in clarifying the exemption of gift annuities from IRC Section 501(m).

Sincerely,

Thomas J. Bachmeyer
Director of Development

Stanley E. Grayson
Chairman, New York City Industrial Development Agency

Thank you for the opportunity to present this statement about the Technical Corrections Act of 1987 (S. 1350). I am Stanley Grayson, Chairman of the New York City Industrial Development Agency (IDA). The IDA has issued 333 federally tax-exempt bonds totalling $483,483,250 since the program's inception in 1976 through 1986, an average of $44 million of bonds issued annually. Virtually all of these projects benefit small companies (less than 500 employees) with an average bond of $1.5 million per firm. This program is very successful and overall has enabled New York City to retain approximately 46,000 jobs and create approximately 27,000 jobs.

However the Tax Reform Act of 1986 has hindered our ability to issue federally tax-exempt IDBs. One major problem is the restrictions imposed by tax reform on the type of companies that qualify for this vital economic tool. Since the beginning of 1987, we have only issued three federally tax-exempt bonds for $8.3 million.

The Tax Reform Act of 1986 provides that interest on private activity bonds, that are qualified small issue bonds, issued after December 31, 1986 will not be excluded from gross income for purposes of federal taxation unless these bonds are issued for a "manufacturing facility." The "manufacturing facility" definition provided in the Act is:

"Manufacturing facility - for purposes of this paragraph, the term "manufacturing facility" means any facility which is used in the manufacturing or production of tangible personal property (including the processing resulting in a change in condition of such property). A rule similar to the rule of section 142(b)(2) shall apply for purposes of the preceding sentence. (Act, Section 1301(b), codified as Section 144(a)(c) of the INTERNAL REVENUE CODE of 1986).

This definition has made it very difficult for us to issue tax-exempt small issue IDBs. We are often unable to obtain clean opinions from our bond counsel because of the lack of clarity in this definition and consequently are unable to market these bonds. The definition fails to give a clear indication of what constitutes manufacturing and unfortunately the legislative history of the bill does not provide any insight. The definition further fails to address whether facilities ancillary to manufacturing (e.g. warehouses, distribution facilities, office space, etc.) fall within he scope of the "manufacturing facility" definition. The "manufacturing facility" definition must be clarified. The best way to do this, in my opinion, is to use the Department of Commerce's Standard Industrial Classification System (SIC). This system would be consistent with Congress' original intent. When the separation was made in the small issue program between manufacturing and non-manufacturing companies in 1984, conversations with congressional staff indicated that their intent was to be consistent with the SIC code definition.

For example, although the printing industry is classified as manufacturing under the SIC code, it is often unclear whether commercial printers fall within the ambit of the new definition and thus qualify for tax-exempt financing. The problem is that the definition is too vague and technology has drastically altered this industry, however, the processes, jobs and economic development benefits are similar to other industries that are more traditionally defined as manufacturing. The definition must be sensitive to both changing technology and the economy. The printing industry is a vital part of the New York City economy; it is the second largest type of manufacturer in the City and has in excess of 90,000 employees. It provides essential infrastructure for the finance, insurance and real estate sectors.

I strongly urge that the committee amend the "manufacturing facility" definition to conform to the manufacturing classification in the SIC code. The SIC definition is not an expansion of the "manufacturing facility" definition but rather a comprehensive and familiar definition that will allow bond counsel to give clean opinions on our projects. The SIC manual is a respected reference book for business and government and would be rational source for this definition. It will give us a clear, workable guideline and will allow us to make quick, consistent decisions on whether a project qualifies for tax-exempt financing.

Whether or not the SIC code is adopted, I further urge, as a separate matter, that independent warehouse and distribution facilities be included as small issue bonds qualifying for the federal exemption. Warehouse and distribution facilities are an integral part of the industrial sector and are necessary to the continued viability of the manufacturing sector. Warehouse and distribution facilities provide access to services and jobs in areas that would otherwise be underserved. The unskilled and semi-skilled jobs that are created as a result of these operations are part of the traditional employment ladder for many immigrants and young people.

Inclusion of warehouse and distribution facilities, along with a clarification of the "manufacturing definition" will not result in a revenue loss to the government. The bond allocation cap on private purpose bonds is a sufficient limit on the volume of bonds that may be issued. Each locality should be able to determine the best use of its limited bonding authority to promote economic development in its area.

The definition I purpose, that would both clarify manufacturing by using the SIC code and expand the definition to include the financing of warehouse and distribution facilities is:

Amend Section 144(a)(12)(c) as follows:

(c) MANUFACTURING FACILITY. --For purposes of this paragraph, the term "manufacturing facility" means any facility which is used in the manufacturing or production of tangible personal (including the processing resulting in a change in the condition of such property) <u>and any facility used for the wholesale trade, packaging, repackaging, warehousing or research and development that is related thereto</u>. <u>For purposes of this paragraph, the term "manufacturing or production" shall include any activity described in Division D of the Standard Industrial Classification Manual</u>. A rule similar to the rule of section 142(b)(2) shall apply for purposes of <u>this paragraph</u>.*

(*Underline means new matter)

IDBs help small and medium-sized businesses access the capital they need to grown and create new jobs in the economy. As many studies have documented, small and medium-sized businesses create the vast majority of the new jobs in this country. I believe this tool is a cost effective and efficient means of promoting economic development. I strongly urge that you consider these suggestions so we can continue to serve the economic development needs across the country.

BY RICHARD FLYNN, CHAIRMAN
NEW YORK POWER AUTHORITY

Mr. Chairman. The New York Power Authority is a statewide public power agency that operates hydroelectric, nuclear, and fossil fuel power plants in New York. It was created by state law in 1931 during the administration of Governor Franklin D. Roosevelt. Currently, the Authority produces and sells more electric power than any of the other 2,144 state and local publicly-owned power agencies in the United States. As Chairman of the Authority, I would like to submit to the Committee the following comments on the Technical Corrections Act of 1987, S. 1350.

Section 113(f)(7)(A) and (B) of S. 1350 clarify that bonds issued by the New York Power Authority under the provisions of section 629 of the 1984 Deficit Reduction Act, as amended by section 1316(g)(8)(A) of the 1986 Tax Reform Act, are eligible for carryforward elections under New York State's tax-exempt bond volume limitation cap. We are most pleased that the Committee has included this provision in S. 1350 and we believe this technical correction is in keeping with the Congressional intent of section 629, as amended.

Section 629 was included in the 1984 Deficit Reduction Act to clarify the tax treatment of certain bonds issued by the New York Power Authority. The clarification was necessary due to certain unique aspects of the Authority's operations. The Authority does not own its own local distribution lines and as a result must sell its electricity wholesale through the State's seven private utilities, which serve 98% of New York's electric customers. The Authority contracts with the private utilities to carry its power through their distribution lines for sale to end-use customers, at no markup in cost. Without its own distribution lines, contracting with private utilities to deliver its power is the only way the Authority can serve 98% of New York's electric power consumers. However, because the Authority enters into contracts with private utility companies, its bonds are subject to being classified as taxable "private purpose" bonds.

Recognizing the unique circumstances under which the Authority operates, Congress added an amendment to the 1984 Deficit Reduction Act clarifying that certain bonds issued by the Authority are to be treated as tax-exempt "public purpose" or governmental bonds. As originally proposed by Senator Moynihan, and approved by the Finance Committee, the 1984 amendment provided for all the Authority's bonds to be treated as tax-exempt "public purpose" or governmental bonds. In Conference Committee, however, Senator Moynihan's amendment, which became section 629 of the Deficit Reduction Act, was modified to authorize the Authority to issue up to $625 million of tax-exempt bonds for certain electrical generation and transmission facilities. In addition, bonds issued by the Authority under section 629 were made subject to the state volume limitation cap. The original Senate amendment, as proposed by Senator Moynihan, and approved by this Committee, did not make the Authority's bonds subject to the state volume limitation cap.

In the Tax Reform Act of 1986, the Senate Finance Committee again addressed the issue of the Power Authority's bonds. At Senator Moynihan's request, the Committee included in its bill a provision amending section 629 of the 1984 Act to increase to $911 million the amount of tax-exempt bonds authorized to be issued and to define additional categories of projects for which such bonds can be issued.

While the statutory language of section 629 treats the bonds as "public purpose" or governmental bonds, the 1984 Conference Committee agreement made bonds issued under section 629 subject to the state volume cap limitation. It was our assumption at the time that for the purposes of the volume limitation cap, the carryforward provisions of the Internal Revenue Code would apply to section 629 bonds. This interpretation, however, appears to need clarification. Sections 113(f)(7)(A) and (B) of S. 1350 clarify the issue for future carryforward elections by making the carryforward provisions in the 1986 Tax Reform Act explicitly applicable to bonds issued after 1986 under section 629 of the Deficit Reduction Act, as amended.

There remains, however, an outstanding issue. Based upon our understanding of the 1984 provision, we believed that allocations of New York's volume cap could be made immediately on a carryforward basis to the Authority for the specified purposes of section 629, particularly for the Long Island Sound Cable facility, which we knew would take several years to design, license, and complete.

The Long Island Sound Cable facility is a proposed transmission line running under Long Island Sound between Westchester and Long Island that will carry about 600,000 kilowatts of lower-cost electricity to Long Island. Construction of the cable project is expected to take place over a three-year period and the capital cost is estimated to be $317 million in 1991 dollars. The cable facility is critical to increasing the reliability and mitigating the cost of electric power on Long Island, as well as decreasing the consumption of imported oil. Use of tax-exempt bond financing for the facility will save Long Island ratepayers approximately $225 million over the life of the bonds. The Long Island Sound Cable is currently in the pre-licensing phase. Because of the importance of this project, New York State allocated $106.5 million of its 1985 volume cap for the Long Island Sound Cable. The carryforward election was made in accordance with then-applicable regulations. Under the circumstances at the time, and because section 629 bonds were "public purpose" bonds, there was no reason to believe that such a carryforward election might be declared invalid. It now appears, however, that certain provisions in the 1986 Tax Reform Act would negate the Authority's 1985 carryforward of $106.5 million for the Long Island Sound Cable.

Unfortunately, S. 1350 does not address this aspect of the carryforward issue for section 629 bonds. Therefore, we respectfully request that language be added to S. 1350 that will preserve the carryforward already elected for the Long Island Sound Cable.

In closing, we would like to thank the Committee for including section 113(f)(7)(A) and (B) in S. 1350 clarifying the Authority's ability to make future use of the carryforward provisions of the 1986 Tax Reform Act. We remain concerned, however, about the potential loss of our carryforward for the Long Island Sound Cable and hope that the Committee will consider resolving this issue by adding an amendment to S. 1350 explicitly authorizing the $106.5 million carryforward.

I appreciate the opportunity to present to the Committee the New York Power Authority's comments on S. 1350 and would like to thank you for your consideration of this matter.

NORTH PACIFIC UNION CONFERENCE ASSOCIATION
of Seventh-day Adventists

ALASKA
IDAHO
MONTANA
OREGON
WASHINGTON

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P.O. BOX 16677

PORTLAND, OREGON 97216
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July 6, 1987

Laura Wilcox
U.S. Senate Committee on Finance
SD 205
Washington, D.C. 20510

Dear Laura Wilcox:

Our organization is greatly concerned about the implications of the Technical Corrections Act of 1987 (HR. 2636) and we are asking that it be amended to clarify that charitable gift annuities issued by IRC Sec. 501 (C) (3) organizations are not "commercial-type insurance" under IRC Sec. 501 (m).

Please note the following statements:

a. Gift annuities are used because our trustors wish to make a gift to help our organization carry out the work of the church they love and belong to.

b. Gift annuities don't compete with commercial annuities and are not "commercial-type insurance".

c. Failing to clarify the law will dry up an important source of funds for our organization's charitable activities.

d. Gift annuities have been used by charitable organizations for over 100 years.

e. A charitable gift annuity, for the small donor, is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501 (m).

It is our hope that you will help us get this bill amended BEFORE it is enacted. Please be our VOICE.

Sincerely,

Leonard L Ayers

Leonard L. Ayers
Trust Service Director

njt

Enclosure 5 copies

NORTHFIELD MOUNT HERMON 1879 SCHOOL

Northfield, Massachusetts 01360

Richard F. Odell
Director of External Affairs

July 6, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

Will you please vote to amend the Technical Corrections Act of 1987 to clarify the fact that charitable gift annuities which are issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

Many of this school's supporters are of modest means, and the charitable gift annuity has proven to be a highly satisfactory way for such donors to make gifts to us while receiving annuity income. These annuitants are motivated primarily by the desire to support the school. The annuity itself is a secondary consideration. If these individuals were looking solely for the most attractive rates of return, they would find that the rates paid by commercial insurance companies are much more generous. In no sense are we trying to compete with insurance companies.

Finally, charitable gift annuities serve exactly the same purpose as annuity trusts but on a smaller scale. Annuity trusts are <u>not</u> affected by IRC Sec. 501(m).

For organizations like Northfield Mount Hermon, this is an urgent situation, and we need your help in order to rectify it.

Sincerely,

Rich Odell

Richard F. Odell

kg

STATEMENT OF THE NORTHERN TEXTILE ASSOCIATION

IN SUPPORT OF S. 549, THE TEXTILE AND

APPAREL TRADE ACT OF 1987

The Northern Textile Association and its member companies strongly support S. 549, the Textile and Apparel Trade Act of 1987. It is our belief that this legislation will prevent the continued deterioration of an important manufacturing industry which has been an integral part of America's industrial history since Colonial days.

Established in 1854 the Boston-based Northern Textile Association (NTA) is the primary voice for textile manufacturers located in New England. NTA members currently include integrated man-made fiber and wool textile mills, pressed felt manufacturers, elastic fabric producers, flock and flocked product manufacturers, as well as cotton and synthetic manufacturers. Most NTA members are medium-sized textile mills, although both large and small facilities are represented. The majority of NTA members are located in the New England area although the Association does have members in all regions of the country.

The textile industry in New England has gone through a significant period of contraction since the end of World War II. Cotton fabric manufacturing, once the focus of this industry in New England, is now performed by only a handful of companies. The textile manufacturing operations which remain tend to be producing specialty products for apparel, industrial, medical, and home furnishings markets.

According to information produced by state and federal government agencies 827 textile manufacturing facilities were located in New England during 1975 providing 60,053 jobs. By 1985, 143 plants had closed and 14,000 jobs were lost. Massachusetts and Rhode Island have absorbed a majority of the plant closings and associated job losses. During the 1975-1985 period shutdowns of textile manufacturing facilities in Massachusetts and Rhode Island resulted in the loss of 8,153 jobs.

Examination of textile and apparel import statistics in conjunction with job loss information reveals a direct relationship between increased foreign penetration of the domestic textile and apparel market and lower industry employment levels. Textile and apparel import levels have nearly tripled since 1980 - from 4.8 billion square yard equivalents (SYE) to more than 12.7 billion SYE in 1986. Imports now claim more than half the U.S. apparel market. During the past five years the industry has lost 350,000 jobs and more than 250 textile mills have closed.

A legislative solution to the textile and apparel import problem is needed because there is no indication that the increasing flood of textile and apparel imports will slow. Imports of textile and apparel products during the January-April 1987 period reached 4.5 billion SYE. This constitutes a new record for the first four months of a year and a six percent increase over the same period in 1986. According to figures recently released by the U.S. Department of Commerce, the January-April 1987 textile and apparel trade deficit totaled a record breaking $7.65 billion, an increase of more than 20 percent over the January-April 1986 period.

One of the largest sectors of the textile manufacturing industry in New England consists of manufacturers of wool fabric and yarn products. These manufacturers have been especially hard hit by overseas competitors. Import penetration into the wool products market went from 19.5 percent in 1975 to 29.0 percent in 1984. In 1980 wool products imports amounted to 129.3 million SYE; by 1985 they had increased 104 percent to 264 million SYE. Although U.S. wool fabric mills have successfully met the demands of apparel makers, home furnishings producers, and users of industrial wool fabrics, retailers, to maximize their markups, are ordering their wool apparel off-shore. These garments, which are manufactured in Far Eastern countries and state-controlled economies, afford retailers a greater margin because of their lower wholesale costs.

New England textile manufacturers, like their counterparts in other regions of the country, have invested heavily in new plants and equipment so that they can increase productivity and compete with overseas competitors. During the past 10 years the textile industry has invested an average of $1.5 billion per year on modernization, fully 80 percent of its internally generated funds. The results are recent productivity increases averaging over 5 percent per year, more than twice the 2.4 percent rate for all American manufacturing.

There is a widespread perception among New England textile manufacturers that the reason they are having difficulty competing with overseas suppliers is that they are not competing on an equal basis. New England has one of the highest regional wage rates in the United States and a massive productivity advantage is necessary when your major overseas competitors are paying their workers less than one dollar per hour. New England states, as well as our federal government, require strict adherence to a plethora of environmental and worker safety regulations. Regulatory obligations are almost nonexistent in many of the developing countries which export textile products to the American market. Foreign competitors also benefit from backing by a low-value currency as well as government assistance in the areas of capital investment and export promotion. Members of the Northern Textile Association have recounted numerous stories of failed attempts to penetrate non-tariff barriers and sell speciality textile products in countries which ship thousands of square yards of textile products to the American market daily.

Textile mills in New England operate in a highly competitive domestic and international marketplace. They also encounter a number of problems unique to textile mills in this area. The New England physical, demographic, and social climate presents special problems for the operation of textile mills. Frequently the mill is one of very few employers in its locale and the community may be very dependent on it for tax resources, sewage treatment financing, and other necessities. Other problems which New England mills encounter include small and often highly competitive labor markets, and operation in a region of the country which has higher than average wage and benefit levels. Although New England textile mills often utilize old physical plants, many have invested heavily in state-of-the-art machinery and equipment.

On behalf of textile manufacturers located in the Northeast region of the United States the Northern Textile Association respectfully requests favorable consideration of S. 549. Enactment of this legislation is crucial if a manufacturing industry which has provided jobs to New England workers for over 200 years is to remain an important part of our industrial base.

**WRITTEN SUBMISSION OF
THE NATIONAL ASSOCIATION OF LIFE COMPANIES
TO THE COMMITTEE ON FINANCE OF THE
UNITED STATES SENATE CONCERNING S. 1350,
THE TECHNICAL CORRECTIONS ACT OF 1987**

The National Association of Life Companies (the "NALC") appreciates this opportunity to submit comments to the Committee on Finance with respect to S. 1350, the Technical Corrections Act of 1987. The NALC is an association of over 500 small to medium-sized life insurance companies domiciled in 48 states, with its headquarters in Washington, D.C.

I. Introduction.

Our comments are limited to two aspects of the new corporate alternative minimum tax ("AMT") which are of concern to small to medium-sized life insurance companies. Under the AMT, a corporation's alternative minimum taxable income ("AMTI") will be adjusted to include a portion of what have been characterized as "business untaxed reported profits." In 1987, 1988, and 1989, this adjustment will be based on "net book income," while in 1990 and ensuing years the adjustment will be based on "adjusted current earnings." The problems we see under these adjustments are as follows:

(1) Some stock life insurance companies and all mutual life insurance companies will use their annual statement gain or loss from operations in determining the amount (if any) of the book income adjustment, while many other stock life insurance companies will determine that amount from a GAAP financial statement, which typically will show a larger amount of "book income."

(2) Under both the book income and the current earnings adjustment, the small life insurance company deduction is in effect treated as a preference item, i.e., a small life insurance company otherwise eligible for the effective rate reduction granted by the small company deduction is denied the benefit of that reduction through the AMT.

In order to correct these problems, the NALC recommends that the following two changes be made in the AMT:

(1) Book income should be defined, in the case of all life insurance companies, as annual statement gain or loss from operations (before Federal income tax).

(2) The small life insurance company deduction should not be treated as a preference item. Specifically, book income or current earnings, as the case may be, should be reduced by the amount of the small company deduction allowed in determining a company's regular taxable income.

A discussion of each of these problems and recommendations follows.

II. **The "book income" of life insurance companies should be measured by annual statement accounting.**

A. Background

1. Regular Taxable Income

In determining the regular taxable income of a life insurance company, the Internal Revenue Code generally uses the figures reported by the company on the annual statement the company must file with State insurance regulators. This statement follows the form prescribed by the National Association of Insurance Commissioners to carry out the accounting requirements imposed on insurers by State statutes and regulations; hence the oft-used reference to annual statement accounting as "statutory" accounting. In instances where the tax rules require a departure from the annual statement figures, as in the case of life insurance reserves under section 807(d), the figures specially computed for tax purposes are derived from annual statement data.

Thus, annual statement accounting is the touchstone for tax accounting. Indeed, mutual life insurers and some stock life insurers have no formal financial report other than the annual statement. On the other hand, many stock life insurers prepare audited GAAP financial statements, either for purposes of SEC filings or for other purposes.

2. The Alternative Minimum Tax

Under the book income adjustment, a life insurance company's AMTI will be increased by one-half of the excess (if any) of the company's "book income" over the company's "pre-book alternative taxable income" (generally, its regular taxable income plus any other enumerated preference items). The company's "book income" is the net income shown on its "applicable financial statement." A life insurance company's applicable financial statement will be either a financial statement filed with the SEC, or if it has no such statement, a certified audited GAAP financial statement, or if it has neither of the foregoing, the NAIC annual statement filed with State regulators.

B. The Problem under the Alternative Minimum Tax

The "book income" adjustment does not treat all life insurance companies equally, i.e., the AMT is not a level playing field. As noted above, many stock life insurance companies prepare GAAP income statements, but many other stock life insurers do not. In addition, no mutual life insurers do so (other than for internal analytical purposes). Thus, all mutual life insurance companies (and some stock companies) will use their annual statement gain or loss from operations in determining the amount (if any) of the book income adjustment, while many stock life insurance companies will determine that amount from a GAAP financial statement.

The differences between a life insurance company financial statement prepared in accordance with generally accepted accounting principles and one prepared in accordance with statutory accounting principles frequently are substantial, with a GAAP statement typically showing a larger amount of "book income." These differences could give life insurance companies which do not prepare GAAP financial statements a competitive advantage over those life insurance companies which do.

C. Recommendation

In order to treat all life insurance companies equally under the AMT during the years 1987, 1988, and 1989, book income should be defined for all life insurance companies as annual statement gain or loss from operations (before Federal income tax). A suggested amendment appears at the end of this statement.

D. Discussion

Just as annual statement accounting has long been the basis for determining the tax liability of life insurers, it should also be of primary relevance in any minimum tax computation. In contrast to other industries where there may be no single, common method of computing book income, the life insurance industry has a nationally uniform set of non-tax books -- the annual statement filed with State regulators. Treating the annual statement gain from operations of life insurers as their exclusive book income will help to ensure an even-handed application of the AMT industry-wide. It would also accord with the 1986 resolution of the National Association of Insurance Commissioners urging Congress to require the use of statutory insurance accounting principles (i.e., the annual statement) in any book income preference computation.

Uniformity aside, as recently as 1984 Congress thoroughly reviewed the tax treatment of life insurance companies, including the long-standing practice of the tax law to make use of annual statement data as the basis of tax computations. Rather than depart from the use of the annual statement, Congress reaffirmed it as the source of the tax computations. Although other-types of earnings statements were known to Congress at that time, they were not employed for the following reasons: (1) a significant number of life insurance companies (including the three largest life insurance companies in the Nation) do not have any financial statement other than the annual statement; and (2) other financial statements will show differences from the annual statement primarily in timing rather than in "permanent" items. These reasons are equally persuasive as to why the annual statement should be used in the AMT.

In sum, to preserve the well considered decisions made by Congress in enacting the life insurance company provisions of the 1984 law, and to ensure a level playing field between segments of the industry, the annual statements that all life insurance companies file with their State regulators (and which are audited by those regulators) should provide the exclusive basis for determining the book income of such companies.

III. The benefit of the small life insurance company deduction should not be reduced by the alternative minimum tax rules.

A. Background

Under section 806, qualifying small life insurance companies may claim the benefit of the "small life insurance company deduction" in computing their regular taxable income. This deduction, enacted as part of the 1984 life insurance tax legislation in place of similar rules under prior law, was intended to reduce the tax rates applicable to eligible small companies. As noted in the House and Senate Reports accompanying the 1984 Act, the small life insurance company deduction results "in effect in a lowering of the tax rates on LICTI" (life insurance company taxable income). See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1404 (1984); S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 528 (1984).

B. The Problem Under the Alternative Minimum Tax

Under both the book income and the current earnings adjustments, the small company deduction is in effect treated as a preference item, i.e., a small life insurance company otherwise eligible for the rate reduction granted by the small company deduction is denied the benefit of that rate reduction under the AMT.

C. Recommendation

The small life insurance company deduction should not be treated as a preference item. Specifically, the AMT should be amended to provide that adjusted current earnings or book income, as the case may be, are to be reduced by the amount of the small company deduction allowed in determining the company's regular taxable income. A suggested amendment appears at the end of this statement.

D. Discussion

Because the amount of the small company deduction is a percentage of an eligible company's otherwise taxable income, the deduction can only reduce the company's tax rate. It cannot produce a loss. The policy behind this deduction has been reaffirmed by its retention by the Tax Reform Act of 1986, which specifically rejected the President's proposal to repeal the deduction.

The 1986 Act, moreover, does not treat other instances of rate relief (such as the graduated rates for smaller corporations) as a preference item subject to the minimum tax. Since the small life insurance company deduction functions in the same way -- rate relief for small life insurance companies -- it, too, should not be treated as a preference item.

IV. Conclusion

In summary, the National Association of Life Companies recommends that the AMT be amended to provide that:

(1) In the case of all life insurance companies, book income is defined as annual statement gain or loss from operations (before Federal income tax).

(2) The small life insurance company deduction is not treated as a preference item.

*   *   *

The member companies of the NALC thank the Committee on Finance for the opportunity to comment on these matters.

Respectfully submitted,

S. Roy Woodall

Executive Vice President

National Association of Life Companies

July 23, 1987

Suggested Statutory Language

Measuring the "Book Income" of Life Insurance Companies by Annual Statement Accounting

To measure the "book income" of all life insurance companies by reference to the annual statement filed with state insurance regulators, the following sentence could be added to I.R.C. section 56(f)(3)(C).

> "For purposes of subparagraph (A), in the case of a life insurance company, the applicable financial statement shall be the annual statement within the meaning of section 809(g)(4)."

Treatment of the Small Company Deduction under the Alternative Minimum Tax

There are two alternative methods of ending the treatment of the small life insurance company deduction as a preference item in the alternative minimum tax. First, either net book income or adjusted current earnings, as the case may be, can be reduced by the amount of the small company deduction allowed in determining the company's taxable income. This result would be achieved by the following amendments:

Method I

(1) Add to I.R.C. section 56(f)(2) the following new subparagraph:

> "ADJUSTMENT FOR CERTAIN SMALL LIFE INSURANCE COMPANIES. -- In the case of a life insurance company, adjusted net book income shall be reduced by the amount (if any) of the small life insurance company deduction allowable under section 806."

(2) Add to I.R.C. section 56(g)(4) the following new subparagraph:

> "ADJUSTMENT FOR CERTAIN SMALL LIFE INSURANCE COMPANIES. -- In the case of a life insurance company, a deduction shall be allowed equal to the amount (if any) of the small life insurance company deduction allowable under section 806."

Method II

Alternatively, a life insurance company's alternative minimum taxable income could be determined without regard to the small life insurance company deduction. This result would be achieved by the following amendments:

(1) Add to I.R.C. section 56(f)(1)(B), after "deduction":

> "and determined without regard to the amount (if any) of the small life insurance company deduction allowable under section 806."

(2) Add to I.R.C. section 56(g)(1)(B), after "deduction":

> "and determined without regard to the amount (if any) of the small life insurance company deduction allowable under section 806."

NATIONAL ASSOCIATION OF ROYALTY OWNERS (NARO)
WRITTEN COMMENTS ON S. 1350
TECHNICAL CORRECTIONS ACT OF 1987

Mr. Chairman and members of the Taxation and Debt Management Subcommittee, NARO makes its comment on one provision of the Tax Reform Act of 1986, subsection 142(c), which amended section 274(h) of the Internal Revenue Code.

Subsection 142(c) of TRA '86 amends Subsection 274(h) of the Code by disallowing any deduction under Section 212 of the Code for conventions, seminars, or similar meetings. Section 212 of the Code allows deductions related to expenses incurred "for the management, conservation, or maintenance of property held for the production of income", among other things.

It is under Code section 212 provision that oil and gas royalty owners take deductions related to expenses arising from their ownership of royalty property.

The Senate Finance Committee Report explained subsection 142(c) of TRA 86 as follows:

> The committee is concerned about deductions claimed for travel and other costs of attending conventions or other meetings that relate to financial or tax planning of investors, rather than to a trade or business of the taxpayer. For example, individuals claim deductions for attending seminars about investments in securities or tax shelters. In many cases, these seminars are held in locations (including some that are overseas) that are attractive for vacation purposes, and are structured so as to permit extensive leisure activities on the part of attendees.
>
> Since investment purposes do not relate to the taxpayer's means of earning a livelihood (i.e., a trade or business), the committee believes that these abuses, along with the personal living expenses, justify denial of any deduction for the costs of attending a non-business seminar or similar meeting that does not relate to a trade or business of the taxpayer (p. 70).

There are numerous differences between the perceived abuse and the actual NARO situation:

1. Naro meetings are not held in exotic locations. Most people do not consider Dallas, Oklahoma City, Austin or Tulsa as prime resort areas (certainly not compared with cruises or trips to California, Florida or Hawaii.)

2. Hotels in these cities are not chosen because of their luxury accommodations, but because they extend reasonable package prices and thus allow as many members as possible to attend the meetings.

3. Informative daily sessions are scheduled from early morning breakfast meetings until 4:00 to 5:00 p.m., leaving little or no time for sight-seeing.

4. The management of mineral/royalty interests has become more complex than just depositing checks into a bank account. The seminars, panels, and discussions are not directed at how to postpone or delay payment of income tax, but are directed at keeping members informed of how to receive income upon which to pay taxes.
5. Meetings are planned for and information is presented, not for the wealthy, but for people who receive minimum income.
6. NARO meetings and seminars allow people from across the United States to meet, share ideas, and hear technical sessions on managing their mineral/royalty interests. For those who do not live in the oil and gas producing states, NARO is often their only available source of information in learning about their assets and source of income.
7. Individuals who own working interests (and report their income and deductions on Schedule C) will be allowed to continue deducting "convention expenses", while those who receive royalty income will be denied the deduction. Given two individuals with an interest in the same well (one a working interest and the other a royalty), it seems highly inequitable for the former to be allowed a deduction, while the latter is denied the same.

It is point number 7 that NARO believes justifies classifying an amendment to Code section 274(h) a technical amendment. In TRA 86, Congress did not eliminate the deduction for attending a NARO convention or meeting for people with high incomes from royalty property (managing their royalty properties may be their trade or business); oil and gas lawyers; accountants; oil and gas landmen; bank officers; oil company executives; independent producers with royalty interests, and so on. So the impact of TRA 86 on royalty owners who are elderly, middle to low income, or widows is greater than other potential NARO convention attendees.

Therefore, although the application of Subsection 142(c) of TRA 86 to certain oil and gas royalty owners may not be because of a drafting "glitch" in TRA 86, the application is surely an unintentional oversight.

NARO proposes that Code section 274(h) be amended as follows (new words underlined):

"(c) Seminars, Etc. for Section 212 Purposes - No deduction will be allowed under section 212 for expenses allocable to a convention seminar, or similar meeting <u>unless the deduction would be allowed under Code section 62(1) as a trade or business deduction attributable to royalty income</u>."

OR "(c) Seminars, Etc. for Section 212 Purposes - No deduction will be allowed under section 212 for expenses allocable to a convention seminar, or similar meeting <u>unless the deduction would be allowed under Code section 62(1) as a trade or business deduction attributable to royalty income; and the convention, seminar or similar meeting is sponsored by an organization described in Section 501(c)6.</u>"

NARO appreciates the Committee's consideration of its position and respectfully requests that the amendment suggested be added to S. 1350.

Statement of the
National Council of Savings Institutions
On S. 1350
The Technical Corrections Act of 1987

The National Council of Savings Institutions appreciates the opportunity to share our views on the Technical Corrections Act of 1987 with the Finance Committee. The National Council is a trade association representing approximately 600 savings banks and savings and loan associations with total assets of $450 billion. Our members include institutions insured by both the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation.

INTRODUCTION

The National Council, on behalf of its member institutions, would like to take this opportunity to congratulate the members of the Finance Committee on the successful enactment of the Tax Reform Act of 1986. The leadership exhibited by the members of the Committee in developing a reform package and securing adoption of the legislation by the full Senate and the Conference Committee was extraordinary.

As with any legislation of such sweeping nature, there are technical problems which surface as the Act is placed in practical application. The outstanding fact is that there are as few items to be corrected as have come to the forefront to date. These potential corrections, however, are of critical importance if the Tax Reform Act is to work successfully in the coming years. The National Council, therefore, will share our comments on issues we have identified which affect the ability of thrift institutions to operate under tax provisions relating to mergers and conversions, extension of "at risk" rules to property sold and financed by thrifts and application of the rate structure and bad debt deduction.

CONVERSION OF THRIFT INSTITUTIONS UNDER THE
FIRM COMMITMENT METHOD OF UNDERWRITING

The National Council supports the provisions contained in Section 106(d)(15) of the bill which make clear that in relation to thrift conversions, an underwriter of an offering of stock under the firm commitment method will not be treated as acquiring any stock of the thrift as long as the stock is disposed of pursuant to the offer. The provision also stipulates that the stock must be disposed of no later than 60 days after the initial offering.

Council members have had difficulty obtaining opinions of counsel that net operating loss carryovers would survive a conversion from mutual to stock if it was completed under the firm commitment method of Underwriting. The confusion was created by the inclusion of Footnote 7 in the Joint Explanatory Statement of the Committee of Conference for Title VI relating to corporate tax provisions (See: House Rep. 99-841, Volume II, Page 178). This footnote had raised questions of whether the underwriter would be a 5 percent shareholder by virtue of the firm commitment offering, even though Federal Home Loan Bank Board and state regulations would prohibit the underwriter from owning or keeping a controlling interest in the stock of a thrift institution. Such a determination would have limited or resulted in the loss of net operating loss carryovers accumulated by the institution before the conversion. The inclusion of the aforementioned language solves the problems and allows conversions to move forward. We applaud the members of the committee and staff for drafting provisions removing the impediment.

The Council does ask that the final language of the bill or the Report accompanying the legislation make clear that the 60 day period required under the statute begins from the time of the firm commitment offering itself and not at the early point when a community offering is made to depositors of the mutual institution. Under banking regulations, mutual institutions are required first to offer options to purchase stock to depositors in the institution for a limited period of time (such as 45 days). If the offering is not fully subscribed by the depositors, the institution then moves forward to the public offering which may be completed using a firm commitment method of underwriting. This is the point at which the clock on the 60 day period should be triggered. While we understand that is the intention of the drafters of the provision that the 60 days apply to the firm commitment offering itself, we urge that this be made clear so that further confusion can be avoided.

INCLUSION OF SAVINGS BANKS IN TWO YEAR WINDOW PERIOD UNDER SECTION 382.

Section 106(d)(15) of the Bill makes clear the savings banks are included in the two-year window period allowed before the imposition of the new Section 382 rules limiting the use of net operating loss carryovers following a conversion. The Council is pleased that the Committee included this correction in the bill so that there will be no question regarding the application of the window period to savings banks.

SUPERVISORY CONVERSIONS AND MERGERS

There are a number of technical problems with the language contained in the Tax Reform Act referencing Section 382 of the Internal Revenue Code as it relates to supervisory conversions and mergers. The Council is pleased that the Technical Corrections Bill does make clear in Section 106(d)(8)(A) that the 20 percent test will be calculated by reference to the value of the deposits and will not require these deposits to have voting power. We also urge the Committee to correct other technical errors in these provisions. First, the Committee should preserve the "scale down" of previous law in regard to supervisory thrift mergers and conversions. It is our understanding that the intention was to extend the provisions of Section 382 in this area as they existed prior to the Tax Reform Act. Unfortunately, the "scale down" was dropped in the drafting. This provision needs to be corrected if FSLIC is to successfully continue to merge problem institutions.

Secondly, the National Council urges the Committee to draft changes to the Tax Reform Act and include provisions in the Technical Corrections Bill which will provide solutions to possible loss of carryovers in situations where the regulators create an interim association owned and operated by the deposit insuring agency until a buyer can be found. Previously, these steps were treated as successive "G" reorganizations and the tax attributes were maintained. This provision is especially important given the problems facing FSLIC in finding buyers for many of the problem institutions still in existence. It will be more necessary than ever for FSLIC to take such interim steps if it is to move foward with elimination of problem institutions.

EXEMPTION FROM EXTENSION OF AT RISK RULES TO SALE OF PROPERTY OWNED BY THRIFT INSTITUTIONS

An area of concern for National Council member thrifts relates to provisions contained in Section 503 of the Tax Reform Act of 1986 which extended the "at risk" loss limitation rules to deductions resulting from real property acquired through the use of nonrecourse financing. While the Act contains exemptions from the rules for third party lenders ("qualified persons") relating to property which is security for nonrecourse loans, this provision does not extend to the sale by these lenders of property owned or property acquired through foreclosure. A sale to a borrower who is a related person may qualify for the exemption as long as any loan is "commercially reasonable" and made on the same basis as loans to unrelated persons. This exemption does not, however extend to loans where the seller is also the financer even if such a loan is completed on a commercially reasonable basis. The extension of the at risk rules to thrifts under these circumstances creates problems for these institutions as they dispose of real estate owned or foreclosed property.

The imposition of these rules could not have come at a worse time. Thrifts are in the process of restructuring and adjusting to declines in the real estate markets in certain geographic areas. In order to complete this process, thrifts must be able to move quickly to dispose of foreclosed property. They have traditionally financed the sale of their own properties. Now thrifts will be required to find alternative financing for the sale of these properties or face increased costs. This is a complicated problem given the economic conditions in some geographic areas and the restrictions under the laws of some states prohibiting recourse financing.

The National Council respectfully requests that this issue be addressed in the final version of the Technical Corrections Bill or in other legislation. One answer may be to extend the commercially reasonable standards applicable to related parties to the sale of real estate owned and foreclosed property by the lender. We will be more than pleased to work with the Committee to find solutions which will allow our members to more quickly and easily dispose of real estate owned and foreclosed property.

INTERRELATION BETWEEN THE THRIFT BAD DEBT DEDUCTION AND THE INVESTMENT TAX CREDIT

Section 109 of the Technical Corrections Bill provides steps for a thrift institution which made an election relating to the investment tax credit (ITC) under previous law, to modify the election and again be able to take advantage of the Section 593 thrift bad debt reserve. We are pleased that this language has been included in the bill. This remedies an inequity which would have penalized institutions for elections made before statutory provisions eliminating the ITC were enacted.

COORDINATION OF THRIFT BAD DEBT RESERVE AND 1987 TAX RATE

One area of concern to the National Council has been the jump in the corporate tax rate facing thrift institutions which are calendar year taxpayers and which are qualified thrift lenders for purposes of the bad debt deduction. This jump in the tax rate impacts calendar year thrift institutions only in 1987. It results from the timing of the phase-down of the 40 percent bad debt deduction to 8 percent beginning on January 1, 1987 combined with the delay in the reduction of the corporate tax rate from 46 percent to 34 percent until July 1, 1987. The resulting increased rate does not fit with the historical intent of the bad debt deduction as a rate modification to encourage investment in housing. The Council would hope that the Committee will agree to provisions which would eliminate this "spike" in the tax rate and which level the rate for 1987 at the 1988 rate.

CONCLUSION

The National Council appreciates the opportunity to share with the Committee our findings on the practical workings of the Tax Reform Act of 1986. We again wish to express our thanks for the consideration already given to several problems and for inclusion of solutions to these in the Technical Corrections Bill. We hope we can move as rapidly and as successfully to solve the additional problem items identified in this statement. The Council staff and members will be willing to work with the Committee to devise workable solutions to remaining areas. If Members of the Committee have questions regarding the provisions outlined in the statement or if the National Council can provide further information, please contact Beth Neese, Director of Tax Legislation, National Council of Savings Institutions, 1101 15th Street, N.W., Washington, D.C. 20515, (202) 857-3100.

THE NEW YORK HOSPITAL

The Honorable Lloyd Bentsen
Chairman
Senate Finance Committee
United States Senate
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of The Society of the New York Hospital (the "Hospital"), I would like to thank the Committee for including in section 113(g) of the Technical Corrections Act of 1987, S. 1350, a corrected version of the transition rule originally granted the Hospital by section 202 of H. Con. Res. 395. I would also like to express my appreciation for this opportunity to explain the Hospital's request that additional language be included in the transition rule to clarify that the Hospital may fully utilize the relief earmarked for it in that rule to complete its modernization program. This supplemental language would not increase the revenue impact of the transition rule as granted in S. 1350.

The transition rule provides that $150 million of nonhospital bonds to be issued for the Hospital's benefit will be exempt from the nonhospital bond volume limitation enacted under the Tax Reform Act of 1986. While the rule, as currently drafted, mentions certain Hospital projects to which the bond proceeds may be applied, it does not expressly refer to the most significant project undertaken by the Hospital: the modernization of its 50-year-old plant. That project, which has been actively planned since 1982, is critical to the Hospital's ability to maintain the highest standards of medical care.

The primary focus of the modernization plan is the renovation of the Hospital's inpatient facilities. Since bonds used to finance such facilities are "qualified hospital bonds" which are not subject to the volume restrictions, transitional relief is not needed in order to finance this principal aspect of the modernization plan. However, an integral part of the modernization project is the renovation of such facilities as the Hospital's research laboratories and medical education and ambulatory care facilities, which are equally critical to the Hospital's ability to provide high-quality medical care. Indeed, certain aspects of the inpatient facility modernization, such as the required expansion of the electrical power generating capacity, cannot be implemented without affecting these "nonhospital" facilities. To the extent the modernization project involves such facilities, financing for the project is subject to the nonhospital bond volume cap. In order to clarify that the $150 million of transitional relief already earmarked for the Hospital may be applied to finance the essential modernization of those facilities, we request that the transition rule be supplemented to read as follows (additional language underscored):

> "(M) Proceeds of an issue are described in this subparagraph if such issue is issued on behalf of the Society of the New York Hospital to finance completion of a project commenced by such hospital in 1981 for construction of a diagnostic and treatment center or to refund bonds issued on behalf of such hospital in connection with the construction of such diagnostic and treatment center or to finance construction and renovation projects associated with an inpatient psychiatric care facility <u>or other facilities of such hospital</u>. The aggregate face amount of bonds to which this subparagraph applies shall not exceed $150,000,000."

The change which the Hospital seeks does not expand the scope of relief beyond that granted last fall. Instead, it simply allows the Hospital the necessary flexibility to continue its modernization within the already agreed upon constraints of the $150 million transition rule included in S. 1350 and H. Con. Res. 395.

Thank you for your consideration in this matter.

Sincerely yours,

John P. Glynn

John P. Glynn
Executive Associate Director
Financial Services

SUPPLEMENTAL STATEMENT OF
THE SOCIETY OF THE NEW YORK HOSPITAL
CONCERNING THE TECHNICAL CORRECTIONS
ACT OF 1987, S. 1350

1.	Witness:	The Society of the New York Hospital 525 East Sixty-Eighth Street New York, N.Y. 10021
2.	Designated Representative:	Charles L. Marinaccio Harry J. Kelly Kelley Drye & Warren 1330 Connecticut Avenue, N.W. Suite 600 Washington, D.C. 20036 (202) 463-8333
3.	Summary:	Requests additional language be included in the transition rule to clarify that the Society of the New York Hospital may fully utilize the relief earmarked for it in that rule to complete its modernization program.

THE TECHNICAL CORRECTIONS ACT OF 1986
S.1350

Statement Of
JAMES C. RICE

My name is James C. Rice. I am President and Chief Executive Officer of NorLight. I appreciate this opportunity to express my support, and the support of my company, for the Technical Corrections Act of 1987, S.1350. As I discuss below, this bill is extremely important to NorLight because it contains a non-controversial provision, inadvertently omitted from the 1986 Tax Reform Act, preserving for NorLight's fiber optic telecommunications network the same Investment Tax Credits ("ITC") enjoyed by NorLight's largest competitors. Accordingly, I join the many other parties testifying and submitting written statements who have urged this Committee, and the Senate at large, promptly to enact this measure.

NorLight

NorLight is a partnership of the wholly owned subsidiaries of five Wisconsin and Minnesota electric utilities: Minnesota Power, Madison Gas and Electric, Dairyland Power Corporation, Wisconsin Power and Light, and Wisconsin Public Service Corporation. The partnership was formed in September 1985, after two years of study, to construct a 670 mile, $41,000,000 fiber optic telecommunications network connecting Minneapolis, Milwaukee, Chicago and numerous other points in Minnesota, Wisconsin and Illinois. The goal of the partners was to deliver state-of-the-art fiber optic-based telecommunications services, not just to the upper Midwest's largest cities, but also to the many secondary and tertiary communities in the region which have been bypassed by larger carriers.

NorLight has proceeded rapidly since its formation to achieve this goal. By December 31, 1985, NorLight had signed binding contracts with vendors to purchase $16,657,000 in electronics, materials and engineering services. By July 1986, NorLight had initiated construction, and commenced service to its first customers in February, 1987. The total cost of the network was $41,000,000, $28,000,000 of which would have qualified for an ITC but for the elimination of the ITC under the Tax Reform Act of 1986.

Tax Reform

Although the Tax Reform Act of 1986 represents a welcome overhaul of the Internal Revenue Code, it has also had the unfortunate, if inadvertent, effect of placing NorLight at a substantial disadvantage vis-a-vis its largest competitors. Section 204(a)(3)(B and C) of the 1986 Act specifically preserved the ITC for capital expenditures made or committed after December 31, 1985, for certain fiber optic telecommunications systems which, in addition to meeting other requirements, either pass through at least ten states or involve a network of more than 20,000 miles. A separate ITC transition rule, however, which would have permitted NorLight's 670 mile, three-state network to qualify for the ITC, was inadvertently omitted from the Conference Committee report issued September 18, 1986 and, ultimately, from the Act as passed by Congress. That provision specifically would have retained the tax credit for a project if

(i) such project involves a fiber optic network of at least 475 miles, passing through Minnesota and Wisconsin; and

(ii) before January 1, 1986, at least $15,000,000 was expended or committed for electronic equipment or fiber optic cable to be used in constructing the network.

When the omission was discovered, this provision was included by the Finance Committee and House Ways and Means Committee (along with other non-controversial technical corrections and transition rules) in the concurrent resolution to the Tax Reform Act, H. Con. Res. 395. The NorLight provision was unopposed throughout House and Senate consideration of the resolution, and received substantial bipartisan support from the

Wisconsin and Minnesota Congressional delegations. Nevertheless, because the House and Senate were unable to agree on certain other, unrelated provisions of the resolution, the NorLight transition rule did not become law.

The loss of the ITC for NorLight's capital investment made after December 31, 1985, effectively increased the cost of NorLight's network by one million dollars. Although the dollar amount involved would be significant to any company of NorLight's size, it is even more significant that NorLight's largest competitors -- those with networks that are 20,000 miles long or that pass through ten or more states -- are at this moment benefiting from the ITC of which NorLight has been deprived. In the telecommunications industry, where competition is stiff, this disparate tax treatment has substantially affected NorLight's ability to compete.

The Technical Corrections Act

The Committee has, by including NorLight's ITC transition rule at section 102(d)(9) of the Technical Corrections Act of 1987, taken the first significant step toward eliminating the Tax Reform Act's artificial distinction between NorLight and its competitors. Further, this provision remedies the situation in which NorLight's provision was inadvertently omitted to the 1986 Tax Act from the Conference Report. The NorLight provision continues to receive overwhelming bipartisan support from the Minnesota and Wisconsin Congressional delegations. Until that provision becomes part of the tax code, however, NorLight will continue to experience competitive harm in the marketplace. Accordingly, for the foregoing reasons, I respectfully urge this Committee and the full Senate to act with all due haste to enact this bill into law.

FINLEY KUMBLE, WAGNER, HEINE,
UNDERBERG, MANLEY, MYERSON & CASEY

Comments of the NOCS Group
to the
Committee on Finance
United States Senate
Regarding
Technical Corrections Act of 1987

July 23, 1987

The NOCS Group ("NOCS") wishes to thank the Committee on Finance for the invitation to comment on H.R. 2636, the Technical Corrections Act of 1987. NOCS takes this opportunity to respectfully request that the attached technical correction be included in some form in H.R. 2636. This language clarifies that institutional purchasers of bonds issued to finance the NOCS-owned cold storage facility in the Remount Road Container Yard in North Charleston, South Carolina may continue to deduct 80 percent of the interest paid to depositors which is allocable to those tax exempt obligations. This statement is submitted on behalf of NOCS by its Washington, D.C. legislative counsel, Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey.

A. Description of the Company and Project

NOCS owns and operates a cold storage warehouse facility on the Cooper River in North Charleston, South Carolina through its wholly-owned subsidiary NOCS South Atlantic Cold Storage & Warehouse, Inc. ("South Atlantic"). South Atlantic was selected by the South Carolina State Port Authority (the "Port Authority") to construct and operate a privately-owned facility that could operate more efficiently than an existing state-owned facility in the Port of Charleston. This facility will attract additional vessels to the Port of Charleston. Ships ordinarily dock and unload at one location on the eastern seaboard. That location is generally determined based on the port's refrigerated container storage capacity since that cargo is the most perishable. The City of Charleston has estimated that it derives between $50,000-$60,000 in revenues for ancillary services for each day a freighter is docked in Charleston. We understand that the Remount Road facility has attracted substantial additional import-export traffic to that port.

South Atlantic agreed to build a modern state-of-the-art container facility in exchange for the issuance of a $4 million industrial development bond to defray part of large initial construction costs. The Company began operating the State's refrigeration facility on January 15, 1986, and signed an irrevocable lease with the Port Authority on May 20, 1986, which required the Company to construct a new facility. We understand that the Company was unaware that the Tax Reform Act, which was ultimately enacted in November 1986, would eliminate the deductibility of tax-exempt interest to the institutional purchaser of their bonds.

The bank holding the bonds has raised the rate of interest to the borrower between 3-4% per year based on this tax change, pursuant to the terms of a Financing Agreement. The Ports Authority has been advised that the unforseeable and retroactive increase in South Atlantic's cost of borrowing will cause South Atlantic to raise cargo rates and become uncompetitive with other ports on the eastern seaboard. Recognizing that this situation will threaten Charleston's increased shipping income, the Ports Authority has contacted members of the State's Congressional delegation who have requested that South Atlantic be included expressly in a transition rule to Section 902(f)(3)(L) of the Act. That section already excludes "Charleston South Carolina waterfront

FINLEY KUMBLE. WAGNER. HEINE.
UNDERBERG. MANLEY. MYERSON & CASEY

projects" from the provision eliminating the ability of financial institutions to deduct the interest paid to depositors which are allocable to tax-exempt obligations (see Exhibit "A" attached).

B. Proposed Revision to the Act

The proposed technical correction to an existing transition rule contained in Section 902(f)(3)(L) of the Act (see Exhibit "B" attached) would specifically list the waterfront projects entitled to transition relief. It would clarify that institutional purchasers of tax-exempt bonds issued for the South Atlantic warehouse project could continue to deduct 80 percent of the interest paid to depositors which are allocable to those tax exempt obligations. The existing transition rule currently provides only a general exemption for "Charleston, South Carolina waterfront projects."

The revenue cost of this clarification is de minimus according to the calculations of Ernst & Whinney (see Exhibit "C" attached). Those calculations suggest that the revenue cost of this classification ranges between $520,000-$1.2 million over the 31 year life of the loan.

C. Arguments in Support of Revision

The provision suggested above would accord to South Atlantic the same tax treatment upon which it justifiably relied when it contracted with the Port Authority to construct a new cold storage warehouse on May 20, 1986 based. This contract was based on State assurance of the availability of the tax-exempt financing. South Atlantic was alerted to the prospect that Section 902 could result in higher interest on bank-held tax-exempt debt late in the tax reform process. They contacted their Congressional representatives and were under the impression that this transaction would be accorded transition relief in the Act. When the legislative language of the Act was reviewed, it contained an exemption for Charleston waterfront projects. South Atlantic was advised that this applied to them. The bond counsel for the institutional lender analyzed the provision and examined its legislative history. He reported that the bank could not rely on this exemption because the Remount Road facility was not specifically mentioned and because there was a waterfront project on the Charleston harbour to which this provision was specifically intended to apply.

The inclusion of this provision has the support of the Port Authority and important members of the South Carolina Congressional delegation. It will result in competitive rates for cargo storage and assist in increasing the utilization of the Charleston harbour. It is, therefore, respectfully requested that some form of this technical correction be included in the Technical Corrections Act of 1987.

/

EXHIBIT A

south carolina state ports authority
Post Office Box 817, Charleston, South Carolina 29402 Telephone 803/723-8651

April 20, 1987

Mr. Kerk Spong
Legislative Assistant
Office of [illegible]ator Strom Thurmond
218 Russe[illegible] [illegible]ate Office Building
Washington, [illegible] 20510-4002

Dear Mr. Spong:

On behalf of the South Carolina State Ports Authority, this is to confirm our strong support of a request by NOCS South Atlantic Cold Storage & Warehouse, Inc., to be included in a transition rule to Section 902 of the Tax Reform Act of 1986. Section 902(f)(3)(C) of the Act currently excludes "Charleston, South Carolina waterfront projects" from a provision eliminating the ability of financial institutions to deduct the interest paid to depositors which are allocable to tax-exempt obligations.

Like the other projects contemplated in the Act as now drawn, the cold storage warehouse is also located on port terminal properties owned by the Ports Authority. The Authority offered to issue industrial development bonds to finance a portion of the warehouse construction, but NOCS relied on the then lower interest rates on tax-exempt debt. In fact, NOCS has committed to incur substantial debt to construct a project of great benefit to the local area in general, and specifically to the Port of Charleston and the Ports Authority. The Authority's obsolete cold storage warehouse and freezer is to be demolished [illegible] contemplation of successful business operations by NOCS. But, the purchaser of NOCS' bonds has now increased its interest rate by 3% - 5% due to the loss of a valuable deduction, and NOCS will have no choice but to offset its increased debt service costs by increasing its rates to store refrigerated cargo. Without the requested help, the Port will undoubtedly lose significant revenues because commercial shippers will elect to load or unload at ports with facilities offering more competitive rates.

Attached is the specific language requested by both interested parties to expand the existing transition rule in fairness to NOCS and for the benefit of the Port of Charleston and the citizens of South Carolina. Again, for the Ports Authority, I reiterate the Authority's strong support of this request, and we greatly appreciate your and the Senator's efforts in this matter.

Please telephone me if I may be of further assistance.

Sincerely,

W M Lawrence

W. M. Lawrence
Chief Financial Officer

WML:jl

Attachment

cc: Mr. John Foster
Mr. Kris Kirkpatrick
Mr. Don Hinson
Mr. Don Welch

BEST AVAILABLE COPY

ATTACHMENT

Section 902 (f) (3) (L) of the Tax Reform Act of 1986 is amended to read as follows:

(L) Charleston, South Carolina, waterfront projects which include two festival market place projects at Union Pier Terminal and the Remount Road Container Yard, State Pier No. 15, at North Charleston Terminal.

EXHIBIT B

Proposed Amendment to Financial Institution
Provision of Tax Reform Act of 1986
Re: Charleston Waterfront Project

Section 902(f)(3)(L) of the Tax Reform Act of 1986 is amended to read as follows:

(L) Charleston, South Carolina, waterfront projects which include: two Festival Market Place projects at Union Pier Terminal and the Remount Road Container Yard, State Pier No. 15, at North Charleston Terminal.

5983I

EXHIBIT C

Ernst & Whinney

920 One Shell Square
New Orleans, Louisiana 70139

Mr. James Farguson
New Orleans Cold Storage
& Warehouse Co., Ltd.
Post Office Box 26308
3401 Alvar Street
New Orleans, Louisiana 70186

Dear Jim:

At your request, I have calculated (using simplified and, in certain instances, highly subjective assumptions outlined below) the total estimated dollar impact on federal income tax collections if the NOCS loan from Hibernia is granted pre August 8, 1986 tax treatment under the provisions of the 1986 Tax Reform Act (TRA). Based upon the assumptions utilized, the present value of the Treasury's net tax collections would be approximately $520,000 lower over the 31 year life of the loan in a "best case" scenario. In a "worst case" scenario, the decrease in tax collections would approximate $1,220,000 over the 31 year life of the loan.

The primary difference in the two scenarios is that the best case assumes a constant interest rate and uses present value factors. The worst case assumes increasing interest rates and does not discount the future lost tax collections back to the present time. Under the provisions of the 1986 TRA [§265(b) and §291(e)(1)(B) of the 1986 Internal Revenue Code], the interest income on the $4,000,000 loan from Hibernia could be tax-exempt to Hibernia under certain circumstances even if the loan was entered into after August 7, 1986. The 1986 TRA would, however, disallow Hibernia an interest deduction, for tax purposes, equal to 100% of the amount of interest expense inputed to the borrowing the Bank incurred to fund the loan. The interest expense deduction disallowance would be imposed because the loan to NOCS by HNB was entered into after August 7, 1986.

If NOCS is successful in obtaining transition relief through the proposed Technical Corrections Act, the loan would be considered to have been entered into before August 8, 1986. The interest expense imputed to the loan would still be subject to a disallowance, but the amount of the disallowance would be limited to 20%. As a result, Hibernia would be able to offer NOCS a lower interest rate.

The following assumptions were used in the calculation of the effect of considering the NOCS loan as a pre August 8, 1986 loan:

- NOCS borrowed $4,000,000 from Hibernia on January 1, 1987.
- During 1987, NOCS pays interest only and makes no principal reductions.
- The loan matures in thirty-one years. In each year after 1987, NOCS will make monthly principal payments of $11,111 (annual principal payments of $133,332). Interest will be paid monthly and will be computed based upon the principal outstanding at the end of each month.
- If the transition relief is not granted, the interest rate in the best case scenario is assumed to be 9% (the rate at

January 1, 1987) over the 31 year period to maturity. In the worst case scenario, the interest rate is assumed to be 9% in years 1-5, 10% in years 7-11, 11% in years 12-16, 12% in years 17-21, and 13% in years 22-31.

- If transition relief is granted, the interest rate in the best case scenario is assumed to be 6% over the 31 year period to maturity. In the worst case scenario, the interest rate is assumed to be 6% in years 1-6, 6.75% in years 7-11, 7.50% in years 12-16, 8.25% in years 17-21, and 9% in years 22-31.

- If transition relief is granted, the 20% interest expense disallowance to Hibernia is assumed to be $40,000 per year in years 1-10, $30,000 in years 11-20, and $20,000 in years 21-31. (These estimates are highly subjective based upon recently published financial information.)

- The federal tax rate applicable to both NOCS and Hibernia is assumed to be 34% in all years.

The effect of the transition relief on Treasury tax collections is computed by comparing tax collections with and without transition relief, as follows:

	Best Case Scenario	Worst Case Scenario
Without Transition Relief		
Interest income taxable to Hibernia	$5,775,000	$6,660,033
Interest expense deductible by NOCS	(5,775,000)	(6,660,033)
Net Effect on Tax Collections	$ -0- (A)	$ -0- (A)
With Transition Relief		
Interest income taxable to Hibernia	$ -0-	$ -0-
Interest expense deductible by NOCS	(3,850,000)	(4,515,022)
Interest expense deductions disallowed to Hibernia	920,000	920,000
	2,930,000	3,595,022
Assumed tax rate	x 34%	x 34%
	996,200	1,222,307
Effect of tax collections without transition relief	-0- (A)	-0- (A)
Decrease in Tax Collections	$ 996,200	$1,222,307
Net Present Value (discounted at 8%) of Decrease in Tax Collections	$ 518,885	N/A

If you have any questions about this matter, please call me.

Very truly yours,

Arthur Parham

Arthur J. Parham, Jr.
Senior Manager

AJP:ze

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SOUTH CAROLINA

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126 FEDERAL BUILDING
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OFFICE OF TECHNOLOGY ASSESSMENT
NATIONAL OCEAN POLICY STUDY

May 14, 1987

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

During consideration of the Tax Reform Act of 1986, a transition rule was agreed to that provided an exemption from Section 902 of the Act for a waterfront project in Charleston, South Carolina. The exemption allows institutional investors to continue to deduct 80% of the interest paid to depositors which is allocable to tax exempt obligations.

Another project, to build a cold storage warehouse on land owned by the South Carolina State Ports Authority, is also located on the Charleston waterfront, and the construction of this facility is important to the continuing vitality of the Port of Charleston.

Representatives of the company responsible for the warehouse, New Orleans Cold Storage, Inc., had contacted the staff of the Finance Committee about the project during debate last year, and mistakenly believed that the warehouse was included within the exemption for the Charleston waterfront project. Bond counsel, however, has indicated that the language is not broad enough to include the warehouse project.

If the company had not erroneously relied on the language included in the Act, an effort would have been made to include them in the bill. Because of the meritorious nature of the project and the minimal expense involved, I encourage you to broaden the transition rule provided already to include the cold storage warehouse.

I have attached language which I believe will provide a solution to this problem. Also attached is an estimate that the cost will be minimal-- between $518,000 and $1.2 million over 31 years.

Thanks for your help. If any additional information is needed, please contact David Rudd of my staff at 4-6121.

Sincerely,

Fritz

Ernest F. Hollings

STROM THURMOND
SOUTH CAROLINA
COMMITTEES

ARMED SERVICES
JUDICIARY
VETERANS' AFFAIRS
LABOR AND HUMAN RESOURCES

United States Senate
WASHINGTON, DC 20510

April 21, 1987

Personal attention

Senator Bob Packwood, Ranking Member
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Bob:

It has recently come to my attention that a transition rule to the Tax Reform Act of 1986, which was included at my request, requires a technical correction. As you may recall, you were kind enough to accept a transition rule to Section 902 of the Act which relates to a bank's deductibility of tax-exempt interest. The transiton rule allows the institutional purchasers of tax-exempt bonds issued for an important waterfront project in Charleston, South Carolina to continue to deduct 80 percent of the interest paid to depositors which are allocable to those tax-exempt obligations (see Vol. I, page 315 of the Conference Report).

The language that was drafted by your staff was intended to be broad enough to include another project on the Cooper River which was brought to their attention. Your staff certainly has exhibited outstanding and professional work throughout this tax reform process and it is understandable how this project might fall through the cracks during the final hectic stage of the tax Conference last year.

This project involves the construction of a cold storage warehouse, located on land owned by the South Carolina State Ports Authority, and owned by a South Carolina subsidiary of an out-of-state parent corporation. This project is essential to encourage the use of the Port of Charleston by commercial shippers. Representatives of the parent company believed that the port project had been taken care of in the language of the transition rule. After the Act passed, company representatives were informed by bond counsel that the language as written was not sufficient to allow the institutional purchaser of the company's bonds to deduct the interest.

I would appreciate your revising the existing transition rule to provide for this project. Attached is suggested language which will satisfy the institutional purchaser of the bonds. I am advised that the revenue cost of this clarification should be _de minimus_; between $520,000 - $1.2 million over the 31 year life of the loan as estimated by the accounting firm of Ernst & Whinney (see revenue estimate attached).

Thank you for your prompt consideration of this matter. If there are any questions, or if additional information is required, please have a member of your staff contact Kerk Spong of my staff at x45972. You have certainly done a splendid job throughout this whole tax reform effort and your invaluable assistance is greatly appreciated.

Sincerely

Strom

Strom Thurmond

ST/rzz

United States Senate

COMMITTEE ON FINANCE
WASHINGTON, DC 20510-6200

May 1, 1987

The Honorable Strom Thurmond
United States Senate
Washington, D.C. 20510

Dear Strom:

Thank you for your letter regarding the Tax Reform Act's transition rule for the waterfront projects in Charleston, South Carolina. I have noted your interest in clarifying the provision to ensure that it applies to a third project on the Cooper River.

We are presently working to finalize the technical corrections bill, which Dan Rostenkowski and I intend to introduce later this month. We will consult with Senator Packwood, as well as with the Ways and Means Committee and the Joint Committee on Taxation, on the legislative history of your provision to see we can accomodate your request.

Thanks again for bringing this matter to my attention.

Sincerely,

Lloyd

Lloyd Bentsen

TESTIMONY OF THE NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION ON S. 1350, THE TECHNICAL CORRECTIONS ACT OF 1987, BEFORE THE SENATE FINANCE COMMITTEE

July 21, 1987

Mr. Chairman and members of the Committee, my name is Anthony C. Williams. I am the Director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association (NRECA) and the Administrator of the various welfare and pension programs sponsored by NRECA for its members. NRECA is the national service organization of the approximately 1,000 rural electric service systems operating in 46 states. These systems bring central station electric service to approximately 25 million farm and rural individuals in 2,600 of our nation's 3,100 countries. Our various programs provide pension and welfare benefits to over 110,000 employees and their dependents in those localities.

I want to express our appreciation to the members of this Committee for their interest in and support of our recommendations for technical corrections to the Tax Reform Act of 1986. The changes we proposed in Section 401(k) and Section 125, as included in S. 1350, resolve two technical issues directly affecting the operation of our plans. We are seriously concerned, however, with the way the correction to Section 401(k) is presently drafted and request your consideration of another definition of a "rural electric cooperative plan".

The Tax Reform Act of 1986 permitted rural electric cooperatives and their allied organizations to provide 401(k) Cash or Deferred Plans to their employees. Section 401(k)(7) provides that a "rural electric cooperative plan" is a defined contribution plan established and maintained by a rural electric cooperative (as defined in Section 457(d)(9)(B)) or a national association of such rural electric cooperatives. Because the Tax Reform Act of 1986 repealed the definition of rural electric cooperatives found in Section 457, I.R.C. Section 401(k)(7) does not have a correct cross reference to Section 457. Therefore, a technical amendment is needed to clarify that the definition of a rural electric cooperative is the same as in Section 457 of the Internal Revenue Code of 1954.

Section 111(e)(3) of S. 1350, the Technical Corrections Act of 1987, make changes to the definition of a "rural electric cooperative plan" that would eliminate its availability to many rural electric cooperatives. It was always intended, because of the relative small size of most rural electric cooperatives, that Section 401(k) plans would be available through a master plan administered by their national association, the National Rural Electric Cooperative Association (NRECA). This section of S. 1350, however, eliminated the words "or a national association of such rural electric cooperatives" from Section 401(k)(7)(B).

Accordingly, we recommend that the words "or a national association of such rural electric cooperatives" be retained in Section 401(k)(7) and that the words "of the Internal

Revenue Code of 1954" be inserted after the words "Section 457(d)(9)(B)" in Section 401(k)(7).

Alternatively, we recommend that the following language be incorporated in place that contained in Section 111(e)(3) for purposes of defining a "rural electric cooperative plan" and that the words "or a national association of such rural electric cooperatives" be retained in Section 401(k)(7):

"(7) RURAL ELECTRIC COOPERATIVE PLAN. - For purposes of this subsection -

(A) IN GENERAL. - The term 'rural electric cooperative plan' means any pension plan -

(i) which is a defined contribution plan (as defined in section 414(i)),

(ii) which is established and maintained by a rural electric cooperative, and

(iii) whose participants are employed by a rural electric cooperative or by any organization at least 80 percent of whose members are rural electric cooperatives.

(B) RURAL ELECTRIC COOPERATIVE DEFINED. - For the purposes of subparagraph (A), the term 'rural electric cooperative' means -

(i) any organization exempt from tax under section 501(a) or described in section 401(k)(4)(B)(i) and engaged primarily in providing electric service, and

(ii) a national association described in section 501(c)(6) which is exempt from tax under section 501(a) and at least 80 percent of whose members are organizations described in clause (i)."

Once again, I wish to thank the Chairman and members of this Committee for their consideration of our concerns and comments.

Oak Grove Lutheran High School
124 North Terrace • Fargo, North Dakota 58102-3899 • (701) 237-0210

July 7, 1987

Dear :

Oak Grove Lutheran High School, founded in 1906, is a mission of the newly organized Evangelical Lutheran Church of America (formerly sponsored by the American Lutheran Church) with an educational ministry to the youth of the church.

It is my understanding that the Technical Corrections Act recently introduced does not clearly state that charitable gift annuities are not "commercial-type insurance". We all hoped it would.

Please amend the Technical Corrections Act of 1987 (H.R.-2636) to clarify that charitable gift annuities issued by IRS Sec. 501(c)(3) organizations are not "commercial-type insurance" and are not subject to IRS Sec. 501(m). Charitable gift annuities are used by our donors because of their interest in supporting a school of the church and certainly do not compete with commercial annuities and are not "commercial-type insurance".

If the law is not clarified, it would eliminate a source of funds needed by our school to continue charitable activities.

Gift annuities have been used by charitable institutions for over a hundred years and without question affords an opportunity for the small donor to participate with their gifts.

Your support of the necessary amendment is requested so that the Technical Corrections Act is not silent regarding charitable gift annuities.

Sincerely,

Howard Correll
Director of Development

HC:cl

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June 29, 1987

Ms. Laura Wilcox
United States Senate Committee on Finance
S.D. 205
Washington, D.C. 20515

Dear Ms. Wilcox:

On behalf of many colleagues and not-for-profit charitable organizations, I earnestly solicit your assistance in seeing that the Technical Corrections Act of 1987 (H.R. 2636) is amended to clarify that charitable annuities are not subject to IRC Sec. 501(m).

We would point out that charitable gift annuities that are issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance under IRC Sec. 501(m). Rather, they are a deferred giving device, and the prime motivation of the donor making a contribution for a gift annuity is to make a charitable gift to help our organization.

Since the charitable organization uses the rates prescribed by the Committee on Gift Annuities, the rates are much lower than those offered by commercial insurance companies, and they are designed so that approximately half of the principal amount of the donated property ultimately becomes part of the charitable organization's asset base.

Failure to clarify the law to specify that charitable gift annuities are not included with commercial annuities or insurance would dry up an important source of funds for our charitable activities in a period when there are already cut-backs in the funding of many social programs. Simply put, charitable organizations which offer gift annuities are not competing with commercial insurers nor offering commercial-type insurance.

The Technical Corrections Act of 1987 needs this amendment and vital correction, and I assure you that your help in accomplishing this will be deeply appreciated on the part of all charitable organizations and personnel.

Sincerely,

Harold P. Hamilton
Harold P. Hamilton
Director of Planned Giving

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HPH/klc

· O H I O · W E S L E Y A N ·

Ohio Wesleyan University
Delaware, Ohio 43015
Telephone 614-369-4431

July 17, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
X.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

Since the passage of the 1986 Tax Reform Act much confusion has existed about the advisability of colleges continuing to offer charitable gift annuities to alumni, parents and friends. For many decades this form of contribution has been a popular one, particularly among those not able to make large gifts to establish separate trusts.

We had been led to believe that the Technical Corrections Bill covering the details of the Tax Reform Act now pending before both the House and Senate would address this issue. Recently I have been told that this is not the case. I hope very much that the Technical Corrections Bill will clarify that charitable gift annuities are <u>not</u> subject to the unrelated business income tax because they are <u>not</u> commercial insurance under section 501(M) of the Tax Reform Act of 1986.

Your attention to this issue which is of great concern to thousands of colleges and universities throughout the country would be very much appreciated.

Sincerely yours,

Bob Holm

Robert A. Holm
Vice President for University Relations

RAH/lfb

COMMENTS BY

OLIN CORPORATION

ON TECHNICAL CORRECTIONS ACT OF 1987

(H.R. 2636, S. 1350)

WINCHESTER GUN COLLECTION

Olin Corporation ("Olin") is requesting transition relief from the provisions of the Tax Reform Act of 1986 which would adversely affect its ability to contribute appreciated property to the Buffalo Bill Memorial Association ("BBMA"). This is not a new issue. It is understood that commitments were made in 1986 to include a transition rule first in the Act and then in Con. Res. 395. For reasons which are not entirely clear, the rule was not included. Based on commitments which were given, we believe the rule may have been inadvertently omitted.

By way of background, Olin made a permanent loan of its Winchester Gun Collection (the "Collection") to the Buffalo Bill Memorial Association of Cody, Wyoming, pursuant to an agreement dated August 28, 1975. Supplemental agreements covering additional items were executed on February 24, 1982, and March 15, 1983. The agreements provide that Olin will transfer ownership of the Collection to BBMA at a future date in a manner most advantageous to the business and charitable purposes of Olin. Due to an ongoing program of substantial contributions to Science Park Development Corporation, a charitable organization, formed by Olin, Yale University and the City of New Haven, and certain other significant contributions, Olin has been unable to utilize all of its charitable contributions on a current basis. As a result, the contemplated contribution of the Collection has been delayed.

The Tax Reform Act of 1986 adversely impacts on Olin's ability to fulfill its stated intention of donating the Collection to BBMA. Specifically, it would treat the appreciated value of the Collection as an item of tax preference subject to the new corporate alternative minimum tax. Given competitive pressures and the resulting pricing constraints on capital-intensive companies, it is anticipated that Olin will be subject to the alternative minimum tax for the next several years. As a result, Olin would derive no tax benefit from a contribution of the Collection.

It should be noted that the Joint Committee on Taxation determined last year that the proposed transition relief would be revenue neutral. This determination was based on a letter from Olin's Chairman to Mr. David Brockway, of the Joint Committee on Taxation, wherein it was stated that absent transitional relief, Olin would indefinitely defer the donation of the Collection to BBMA.

Therefore, Olin is again requesting that transitional relief be provided. Suggested legislative language follows:

Olin Corporation

Proposed Statutory Language
For Alternative Minimum Tax
Transition Rule
For Certain Charitable Contributions

"Notwithstanding any provision to the contrary, no alternative minimum tax shall be imposed by reason of any charitable contribution of property made pursuant to a loan and contribution agreement dated August 28, 1975, and supplemented by agreements dated February 24, 1982 and March 15, 1983.

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RAY E. SMITH, GENERAL SUPERINTENDENT
PATRICK L. BOWLIN, GENERAL SECRETARY/TREASURER

2020 BELL AVE., DES MOINES, IOWA 50315-1096
PHONE AREA CODE (515) 288-6761

ROBERT J. HAYNES, FIELD DIRECTOR
2682 CHAMBERS, EUGENE, OR 97405
RES PHONE (503) 485-0286

July 1, 1987

Laura Wilcox
U.S.Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

We would urge The Committee working on the Technical Corrections Act to clearify the status of the CHARITABLE GIFT ANNUITIES, that they ARE NOT, nor should they be treated as "Commercial-type insurance", for the following reasons:

1. Gift Annuities don't compete with commercial annuities and are not "commercial-type insurance" -

2. Gift Annuities have been used by charitable organizations for over 100yrs.

3. For a small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501(m).

4. Failure to clarify the law would dry up an important source of funds for many charitable organizations.

Thank you for your attention to correct this oversight!

Sincerely yours for good government,

Robert J. Haynes
Field Director

P.S. We would also protest the repeal of the charitable deduction as an offset against the genertion-skipping tax on charitable lead trusts; 1.This change is clearly substantive. Chairman Rostenkowski clearly stated ".this legislation is not intended or designed to make substantive changes to last years Act." 2.Changing technical formulas to eliminate deductions is bad policy, discouraging an important source of support for charitable institutions.

Creating ABIDING TREASURES

July 10, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
SD 205
Washington, D. C. 20510

Dear Ms. Wilcox:

I am writing to you and to the Senate Finance Committee to express concern over the fact that the Technical Corrections Bill would, if enacted, discourage establishment of many Charitable Lead Trusts. The Technical Corrections Bill would repeal the charitable deduction in computing the generation-skipping transfer on lead trusts created after June 10, 1987, by striking out IRC Sec. 2642(a)(2)(B)(ii)(II).

This change, if enacted, would discourage an important source of endowment for many charitable organizations.

When coupled with other legislative changes affecting charitable organizations--1) sunsetting on non-itemizers' charitable deductions; 2) appreciation element of gift as an alternate minimum tax preference item; and 3) proposed change in treatment of charitable gift annuities under IRC Sec. 501(m), as subject unrelated business income tax--this proposed change affecting charitable lead trusts will have a very grave impact on charities.

Sincerely,

Daniel D. Ott

Daniel D. Ott
3809 N.W. 9th Place
Gainesville, FL 32605

DDO/irs

July 21, 1987

STATEMENT OF
OVERSEAS SHIPHOLDING GROUP, INC.
TO THE COMMITTEE ON FINANCE

Re: Proposed Technical Corrections to Provisions Taxing Previously Excluded Shipping Income of U.S. Controlled Foreign Corporations

This statement is submitted on behalf of Overseas Shipholding Group, Inc. ("OSG") for inclusion in the record of private sector comments on S. 1350, the proposed Technical Corrections Act of 1987. OSG is a U.S. corporation which, directly and through various subsidiaries and affiliates, is engaged in the ocean transportation of liquid and dry bulk cargoes in both the worldwide and U.S. markets. Certain of OSG's shipping subsidiaries are controlled foreign corporations ("CFCs"), thus making OSG subject to taxation under Subpart F of the Internal Revenue Code (the "Code") with respect to the income of these subsidiaries.

1986 Repeal of the Reinvestment Exclusion

In section 1221(c) of the Tax Reform Act of 1986 (the "1986 Act"), Congress repealed the reinvestment exclusion for foreign shipping income of a CFC, effective for taxable years beginning after December 31, 1986. As a result, the U.S. shareholders of a CFC will be taxed currently on all post-1986 earnings derived from the CFC's foreign shipping operations.

In making this change, Congress intended to tax current shipping income on a prospective basis. However, because Congress failed to modify the rules governing the taxation of withdrawals of investment in shipping (particularly those which occur only by virtue of a required adjustment to the basis of depreciable assets), a CFC's U.S. shareholders may be subject to taxation even on pre-1987 earnings, a presumably unintended result. This increased exposure to tax with respect to prior earnings, in combination with full taxation of current earnings, will make it extremely difficult for U.S. shippers to compete with foreign-owned operations, thus threatening the viability of the U.S.-controlled foreign fleet.

The Denial of Depreciation Deductions

While the proposed legislation (S. 1350) properly addresses a technical flaw in the 1986 Act's formula for calculating investment decreases (by ensuring that withdrawals of previously excluded Subpart F income from qualified shipping reinvestments are taxed only once), it fails to incorporate a more fundamental change that is needed to prevent ordinary depreciation allowances from accelerating the current taxation of pre-1987 earnings. Under section 955 of the Code, CFCs will still be required to actually increase investments abroad just to avoid generating current tax liabilities on amounts reinvested in depreciable shipping assets in prior years. This perverse result occurs because, under current law, the amount of investment attributable to "property" is determined by the property's "adjusted basis." See section 955(b)(4) and Treas. Reg. § 1.955A-2(g)(1). Thus, a

CFC which maintains, but does not increase its fleet, will be subject to tax on the amount by which the basis of its property is adjusted for depreciation each year.

A simple example illustrates the impact of depreciation in the calculation of investment decreases. Assume that under prior law, a CFC has previously deferred $50,000 in earnings by reinvesting such earnings in shipping. At the close of its 1986 tax year, it owns a single ship that has an adjusted basis of $50,000. The ship generates yearly depreciation deductions equal to $5,000. Thus, in each succeeding taxable year, the adjusted basis of the CFC's ship will decline by $5,000. As a result of the required adjustment to the basis of its asset, and assuming the CFC makes no new investments, the U.S. shareholder of the CFC will have to recognize an additional $5,000 in income each year until the ship is fully depreciated. In effect, taxpayers who hold depreciable shipping assets are denied the benefit of depreciation deductions, since the amounts deducted as depreciation will trigger immediate recapture of a corresponding amount of previously deferred income.

Proposed Technical Amendment to Section 955

In order to prevent ordinary depreciation allowances from accelerating the current taxation of pre-1987 tax deferred earnings, section 955 should be amended to (1) exclude post-1986 depreciation allowances on assets placed in service in foreign base company shipping operations on or before December 31, 1986 from the calculation of investment decreases and (2) limit the continued exclusion attributable to such depreciation allowances to make it progressively unavailable to companies that derive less than 65% of their gross receipts from shipping. In addition, to the extent that previously excluded earnings continue to have the benefit of tax deferral, all such amounts should be subject to tax upon repatriation to the CFC's U.S. shareholders.

The exclusion of post-1986 depreciation allowances from the calculation required under section 955 could be accomplished by providing that if a decrease in the level of qualified investment occurs after December 31, 1986, such decrease shall be taken into account under section 955 only to the extent that it exceeds the "Accumulated Depreciation Amount." The "Accumulated Depreciation Amount" would be defined as the cumulative amount of depreciation allowed or allowable in taxable years beginning after December 31, 1986 (up to and including the present taxable year) with respect to assets placed in service in foreign base company shipping operations before that date.

In order to discourage shipping companies from allowing their fleet to depreciate simply as a prelude to liquidating their shipping operations, continued deferral of tax on the Accumulated Depreciation Amount would be fully available only to a CFC which is a "qualified shipping company." For any taxable year, a "qualified shipping company" would be defined as a CFC that derives an average of not less than 65% of its gross receipts over the immediately preceding three-year period from foreign base company shipping activities. As explained more fully in the memorandum which has previously been provided to the staff of the Committee, if a CFC failed to meet the 65% test, then a portion of the accumulated depreciation amount would be taken into income in the relevant year.

A simple example illustrates the mechanics of the proposed amendment. At the close of its 1986 taxable year, a CFC has qualified investments consisting of one ship with an adjusted basis of $120, and previously deferred earnings of $100. In the next three taxable years (calendar years 1987-1989), the CFC takes depreciation allowances of $20 per year. Thus, the ship's adjusted basis declines by a total of $60. Under the 1986 Act, this decline in basis would normally trigger the inclusion in income of a corresponding amount of previously deferred earnings. Under the proposed amendment, no such inclusion in income would result so long as the CFC meets the "65% test" and thus is a "qualified shipping company."

Suppose, however, that the CFC began to diversify its income-producing activities and that in 1988, it derives less than 65% (using the three-year averaging method) of its gross receipts from shipping. Consequently, a statutorily determined percentage of its 1988 Accumulated Depreciation Amount of $40 would be recaptured in that year, thereby forcing the inclusion in income of a proportionate amount of previously deferred earnings.

Rationale for the Proposed Amendment

There are several reasons why the proposed amendment should be adopted. First, the amendment to section 955 is necessary to counter the liquidation incentive inherent in the repeal of the reinvestment exclusion. Predictably, the 1986 Act will result in a phasing out of U.S. participation in international shipping. This is the consequence of combining the new law's repeal of the reinvestment exclusion for current earnings with its requirement that previously deferred earnings be included in income when investment in international shipping declines below 1986 levels.

Suppose that we consider separately these two aspects of the new law, starting with the impact of current taxation of CFC shipping income. Taxation of shipping income on a current basis under the 1986 Act tilts the playing field against U.S. companies, because their foreign competitors generally are free from any comparable tax burdens. This is not a viable position for U.S. operators in the highly competitive international shipping market. The lower cash flow resulting from their new tax burden and associated impairment of competitive position will reduce both their incentive and ability to reinvest. Thus, the taxation of current earnings will make it difficult for CFCs to make the new investments needed simply to maintain the existing level of their international shipping assets in the face of normal depreciation. However, unless CFCs make such fresh investments, they will become subject to tax not only on their current earnings, but also on tax-deferred earnings from prior years.

As U.S.-controlled shipping companies experience the joint effects of paying taxes on current as well as prior years' income, the U.S. shareholders of a CFC will be under strong pressure to cause the CFC to liquidate its shipping assets. This may be the only feasible way of raising the necessary cash since, to obtain deferral in the first place, the CFC had to invest substantially all prior income in shipping assets, most of which are non-liquid in nature. Moreover, to the extent that shipping assets are liquidated to pay current taxes, further tax liabilities will arise under the disinvestment provisions. In short, retention of the disinvestment penalty in the absence of the reinvestment exclusion will create a "vicious circle", which may ultimately drive U.S.-controlled operations into complete liquidation.

Second, the proposed amendment is necessary to avoid disparate treatment in the taxation of current income where one CFC had substantial income in pre-1987 years while another CFC had losses (or no net income) in those years. In such cases, the CFC which has been profitable will lose the benefit of current depreciation in the absence of offsetting fresh investments while the CFC which has not been profitable has no prior deferrals to be "recaptured" as a result of depreciation-induced disinvestment. This produces the result that profitable CFCs are treated less favorably under the 1986 Act than are CFCs with a history of losses. A previously unprofitable CFC (or a new CFC engaged in shipping for the first time) will enjoy the benefit of current depreciation in computing current income no matter what disposition it makes of its current income. We see no tax policy reason why the tax laws should make it more difficult for profitable CFCs to compete with other CFCs, as well as against their international competition.

Third, although depreciation has historically been treated as a reduction in investment under Subpart F, one can question whether the inclusion of depreciation deductions in the measurement of investment decreases is appropriate given the underlying objectives of Subpart F, as amended by the 1986 Act. Subpart F provides for the current taxation of the net earnings of a foreign corporation that are available for distribution as a deemed dividend to the corporation's U.S. shareholders. Since depreciation repesents an allocation of the capital cost of the asset, it must be reflected in determining the amounts available for distribution.

Respectfully submitted,

Donald V. Moorehead
Patton, Boggs & Blow

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WRITER'S DIRECT DIAL NUMBER
(212) 698- 2520

July 16, 1987

EXPRESS MAIL

James C. Gould, Esq.
Chief Tax Counsel
Senate Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Section 111B(i)(1) of the Proposed Technical Corrections Act of 1987 -- Transfers of Proceeds to Other Qualified Plans Upon Termination of Certain Employee Stock Ownership Plans

Dear Mr. Gould:

In response to Chairman Bentsen's invitation for comments on the proposed Technical Corrections Act of 1987 (H.R. 2636, S. 1350), as introduced on June 10, 1987 ("TCA"), I am writing to call your attention to the provision contained in TCA section 111B(i)(1). As explained below, we believe the proposed correction does not reflect clearly the legislative intent of the provision of the Tax Reform Act of 1986 ("TRA") to which it relates.

In general, in order to meet the requirements of present section 409(d) of the Internal Revenue Code of 1986 (the "Code"), as amended by TRA section 1174(a)(1), a payroll-based tax-credit employee stock ownership plan (a "tax-credit ESOP") must provide, among other things, that:

> no employer security allocated to a participant's account . . . may be distributed from that account before the 84th month beginning after the month in which the security is allocated to the account. To the extent provided in the plan, the preceding sentence shall not apply in the case of --
>
> (1) death, disability, separation from service, or termination of the plan. . . .

The exception to the so-called "84-month rule" in the case of a "termination of the plan" was added by TRA section 1174(a)(1).

The General Explanation of the Tax Reform Act prepared by the Joint Committee on Taxation (the "Blue Book") makes clear that Congress intended to permit, upon the termination of a tax-credit ESOP, the sale of allocated employer securities and the subsequent transfer of the proceeds to another existing qualified plan:

> Under [TRA], distributions from a tax-credit ESOP are permitted upon the plan's termination provided no successor plan is established regardless of whether the 84-month rule has been satisfied. [TRA] provides that the sale of securities held by a tax-credit ESOP, and the transfer of those proceeds to another qualified plan, is permitted upon the termination of the ESOP. Blue Book, p. 715 (emphasis added).

Distributions upon termination of a tax-credit ESOP were also discussed in the Blue Book, at page 838, where it was stated that a technical correction might be required with respect to (1) the "successor plan" rule referred to at page 715, and (2) the requirement (not contained in TRA) that qualifying termination distributions must consist of the entire balance to the credit of the participant. It would appear that section 111B(i)(1) was intended to make technical corrections to address these problems.

Although TCA section 111B(i)(1) does address these two problems, it also appears to obscure the congressional intent as enunciated in the Blue Book at page 715 to permit assets to be transferred directly to another existing qualified plan. In this connection, Code section 409(d)(1), as proposed to be amended by TCA section 111B(i)(1), would not except from the 84-month rule any termination distribution, but rather would limit the exception to "lump-sum distribution[s] . . . upon the termination of a plan without the establishment of a successor plan." We respectfully submit that the reference to a "lump-sum distribution" in proposed section 409(d)(1) could be interpreted to require distributions directly to participants, in derogation of the clear intent to permit direct transfers of cash (and, *a fortiori*, stock transfers) to other qualified plans. Thus, with respect to direct transfers, the proposed TCA section 111B(i)(1) amendment of Code section 409(d)(1) could effect a substantive change that would result in the retroactive imposition of severe adverse tax consequences in the case of transactions that have occurred in reliance on the existing statutory language. *See* TRA § 1171(c)(2).

It should also be noted that a lump-sum distribution generally consists of a total distribution from all similar plans maintained by a plan sponsor (see Code § 402(e)(4)(C)). Thus, if section 409(d)(1) were to be amended as proposed by TCA section 111B(i)(1), a distribution in connection with a plan termination of a tax-credit ESOP, where another plan of the same type is also maintained by the same sponsor covering the same participants, might not be permitted. There is no indication in any of the legislative history of TRA that Congress intended not to allow distributions from a terminating stock bonus (or other type of) tax-credit ESOP where the sponsor also maintains a second stock bonus (or such other type of) plan.

To avoid these results, we would suggest as an alternative that TCA section 111B(i)(1), as currently drafted, be replaced by the following provision (marked to indicate our proposed additions):

> (1) Paragraph (1) of section 409(d) of the 1986 Code (relating to securities must stay in the plan) is amended by striking out "or termination of the plan" and inserting in lieu thereof "lump-sum distribution (within the meaning of section 401(k)(10)(B)(ii), determined without reference to section 402(e)(4)(C)) upon termination of a plan without the establishment of a successor plan, or direct transfer of the balance of such account, to a trust exempt from tax under section 501(a) established under a plan described in section 401(a), upon termination of a plan without the establishment of a successor plan".

We will be available to meet with you to discuss any questions you may have with respect to the foregoing.

Respectfully submitted,

Evelyn A. Petschek

Andrew L. Oringer

cc: Randolph H. Hardock, Esq.

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July 21, 1987

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Technical Corrections Act of 1987

Section 116(a)(5) of the Act, amending
Code Sections 501(c)(25) and 514(c)(9)

Dear Ms. Wilcox:

On behalf of several members of the exempt organization community, I write to express deep concern about a proposed change in the unrelated business taxable income rules affecting debt-financed real property owned by tax-exempt Section 501(c)(25) title-holding companies. The changes proposed by Section 116(a)(5) of the Technical Corrections Act reverse a substantive provision of the Tax Reform Act of 1986 without providing an opportunity for substantive hearings.

The provisions affected by this proposal are found in Sections 501(c)(25) and 514(c)(9)(E)(iii) of the Code. Prior to the enactment of the 1986 Act, only pension funds qualified under Section 401(a) of the Code and educational organizations described in Section 170(b)(1)(A)(ii) were permitted to invest in debt-financed real estate without being subject to the tax on unrelated business taxable income under Sections 511 and 514. However, in Section 1603 of the Tax Reform Act of 1986, Congress created a new category of tax-exempt organization -- title-holding corporations or trusts organized for the exclusive purpose of acquiring and holding title to real property, collecting the income therefrom and remitting the income (less expenses) to one or more specified categories of tax-exempt organizations that are shareholders of the corporation or beneficiaries of the trust. In a companion amendment, Congress provided that these new title-holding companies were to be exempt from the tax on debt-financed income under Code Section 514. Thus, because the permitted categories of shareholders of the new Section 501(c)(25) title-holding organizations included tax-exempt charitable organizations, Congress provided a mechanism to correct the inequitable and anachronistic distinction which had previously existed and to permit organizations described in Section 501(c)(3) to participate in leveraged real estate investments on the same basis as pension funds and universities.

There is ample -- indeed overwhelming -- evidence that Congress knew what it was doing when it enacted these provisions and that it intended the result which the statute now provides. To characterize the 1986 Act provisions as technically flawed makes a mockery of the explicit language of the legislative history of these sections. Thus, the co-sponsor of the provision (originally proposed as H.R. 3301), Congressman Robert Matsui, stated in his introductory remarks:

> "[T]his bill provides that section [501(c)(25)] organizations will be eligible for the acquisition indebtedness rules enacted in 1980 for pension plans, thus removing another inconsistency with respect to investment by tax-exempt organizations."

131 Cong. Rec. E 4025 (Daily ed. Sept. 12, 1985).

The Treasury Department agreed with this expression of intent, stating specifically that the purpose of the legislation was to extend the existing exemption to the debt-financed property rules to all qualified charitable shareholders of these new title-holding companies:

> "H.R. 3301 also would extend to collective real estate investment corporations the provision of current law that generally exempts certain real estate investments of qualified pension trusts and educational organizations from the debt-financed property rules. By extending the exception to such corporations, the bill indirectly would extend the exception to all organizations eligible to own beneficial interests in such corporations."

Miscellaneous Tax Bills, Hearings Before the Subcommittee of Select Revenue Measures of the House Ways and Means Committee, 99th Cong., 2d Sess. 190 (May 19, 1986). The Treasury Department testified that, "in their present form, the rules make an untenable distinction between educational organizations and other section 501(c)(3) organizations." Id.

Members of the exempt organization community are dismayed to find that a provision of the Tax Reform Act which Congress and the Treasury Department both supported and which, therefore, was not the subject of Congressional debate, is now arbitrarily threatened with extinction as no more than a clerical error. Nowhere in the Joint Committee's description of the proposed amendment is there any explanation -- or even an intimation -- of why or how this proposal cures an oversight or clerical error. No matter how its proponents attempt to describe it, this proposal is not a technical amendment; it is, instead, a profound and clearly substantive change in the provisions of the 1986 Reform Act.

Because it is substantive rather than technical, because it would perpetuate the inequitable and illogical distinction in the tax treatment of universities and pension plans, on the one hand, and charitable organizations, on the other, and because it contravenes the conscious and unambiguous intent of Congress in enacting Code Section 514(c)(9)(E)(iii), the amendment proposed in Section 116(a)(5) of the Act is inappropriate, indeed unjustified, as a "technical" correction of the 1986 Act. To permit the proposal to "slip through" unnoticed as part of an unprecedentedly voluminous technical correction act would violate the basic principles of candor, fairness and opportunity for hearing which are ingrained in our legislative processes. This provision should not be enacted.

Very truly yours,

Robert H. M. Ferguson

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July 20, 1987

Ms. Laura Wilcox
Committee on Finance
United States Senate
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Re: Proposed Amendment to S.1350 to Modify Additional Tax on Early Distributions by Pension Plans

Dear Ms. Wilcox:

This letter is submitted on behalf of Marathon Oil Company ("Marathon") for inclusion in the record of comments to the Subcommittee on Taxation and Debt Management on S.1350, the proposed Technical Corrections Act of 1987.

The Tax Reform Act of 1986 (the "1986 Act") imposes a 10% penalty tax on so-called "early distributions" from a qualified retirement plan which are made in taxable years beginning after December 31, 1986. Subject to a series of exceptions, an early distribution is one which is made before the recipient attains age 59½. One of these exceptions (the "early retirement" exception) applies where an employee, who has attained age 55, is thereafter separated from service and meets the requirements for early retirement under the qualified plan (section 72(t)(2)(A)(v) of the Code). Some employees who would qualify for this "early retirement" exception but for the fact that they retired before reaching the age 55 may nevertheless avoid the penalty tax if they meet either one of two limited transition rules (described more fully below) contained in the 1986 Act.

The imposition of an age limitation on the early retirement exception discriminates against those employees who participate in plans permitting early retirement prior to age 55 and Congress should at an appropriate time either delete the age limitation or apply the age limitation to the date on which benefits are received rather than to the date on which the employee retires. Moreover, as explained more fully below, the age limitation is particularly unfair to certain employees who retired before the date of enactment of the 1986 Act. To remedy this unfair and retroactive application of the penalty tax, a provision should be included in S.1350 exempting from the penalty tax any distribution to certain employees who retired before August 16, 1986 (the date of final Conference Committee action with respect to the 1986 Act) pursuant to the early retirement provisions of a plan whether or not the individual had attained age 55 on the date he or she retired.

Application of Penalty Tax. As noted above, the "early retirement" exception to the penalty tax does not apply unless the employee has attained age 55 on or before the date of retirement. Section 1123(d)(3) of the 1986 Act exempts from the penalty tax distributions to employees who, as of March 1, 1986, had retired and were separated from service (whether or not they had attained age 55) and had commenced receiving benefits pursuant to a written election designating a specific schedule of benefit payments. Section 1124(a) of the 1986 Act contains a second transition rule under which the penalty tax does not apply to lump-sum distributions made after December 31, 1986 and before March 15, 1987, but only if the employee separated from service during 1986 and agrees to treat the distribution as having been made in 1987.

The combined effect of these three rules is that an employee who retired, pursuant to the early retirement provisions of a plan, before reaching age 55 and before the date of enactment of the 1986 Act will be subject to the penalty tax on all post-1986 distributions unless either another exception applies (such as that for joint and survivor annuities) or the distribution qualifies under the lump-sum distributions transition rule of section 1124(a) of the 1986 Act. As explained below, this unfairly subjects certain retirees to the penalty tax on a retroactive basis.

Reasons For Change. The unfair manner in which the penalty tax can be applied is aptly illustrated by the situation faced by 134 employees, aged 50 through 54, of Marathon who elected to take early retirement on July 1, 1986 pursuant to the terms of qualified retirement plans maintained by Marathon. While each of these employees was entitled to take their entire accrued benefit in the defined benefit plan as a lump sum during July of 1986, each elected to transfer that benefit, via a taxfree "rollover", to a defined contribution plan (the "Thrift Plan") maintained by Marathon. Under the terms of the Thrift Plan, these retirees may elect from a broad range of options for having their benefits distributed to them. Under the Thrift Plan, these 134 employees were entitled to average annual annuities (including the amounts attributable to the rollover) ranging from $17,632 to $35,196. Most of these retirees had undistributed benefits as of January 1, 1987.

However, even though these individuals retired before the Conference Committee completed action on the 1986 Act, and even though they could have avoided the early distribution penalty tax by taking lump sum distributions in July 1986, they will now be subject to that tax unless they either defer all distributions until they reach 59½ (or die or are disabled) or elect to receive their benefits as a qualified annuity under section 72(t)(2)(A)(iv) of the Code. This is unfair for several reasons. First, because these employees made a rollover in July, 1986 (before the Conference Committee completed action on the 1986 Act), they were not eligible for a lump sum distribution from the Thrift Plan in 1986 that would be subject to 10-year forward averaging. Thus, these employees could not take advantage of the second transition rule to avoid the 10% penalty. Second, as noted, had such employees elected the lump sum distribution option in July 1986, instead of making a rollover to another qualified plan, they would not have been liable for the penalty tax. There is no discernable tax policy reason why these employees should be subject to the penalty tax by reason of their choice to take their benefits in one particular form. Third, at the time (July 1, 1986) these employees had to elect to take early retirement (and make their benefit distributions decisions), the Conference Committee had not yet concluded action on the 1986 Act. These employees should not be held to a standard requiring them to have anticipated that the Conference Committee would apply the penalty tax retroactively to employees who had already retired. This is particularly true given the statements that had theretofore been made repeatedly by the Administration and by Congressional leaders concerning the goal of avoiding retroactivity (at least in nonabusive cases) in structuring the 1986 Act.

Proposed Amendment. For these reasons, Congress should act to prevent the application of the early distribution penalty tax to those who retired before the completion of Conference Committee action on the 1986 Act. The present transition rule (which requires retirement as of March 1, 1986 and the receipt of specific pattern of benefits) is too strict as a matter of policy. Therefore, section 1123(e) of the 1986 Act should be amended by adding the following new paragraph at the end thereof:

> "(5) Certain Early Retirements. The amendments made by this section shall not apply to any distributions to an employee from a plan maintained by an employer if such employee separated from service after attaining age 50 and before August 16, 1986 on account of early retirement pursuant to the terms of any plan maintained by such employer, but only if such employee was eligible to elect under such plan to have his entire accrued benefit distributed, on or before December 31, 1986, as a lump sum."

Respectfully submitted,

Donald V. Moorehead

Donald V. Moorehead

July 23, 1987

Comments for the Senate Committee on Finance
Regarding S. 1350, the Technical Corrections Bill

Re: Section 114(g)(2)(D), Generation-Skipping Transfer Tax Transition Rule for Persons with Mental Disabilities

I. Introduction

Section 1433(b)(2)(C) of the Tax Reform Act of 1986 (the "Reform Act") provides that the new generation-skipping transfer tax (the "GST tax") does not apply to certain transfers if the transferor on the date of enactment and at all times thereafter is under a mental disability to change the disposition of his property. Section 114(g)(2)(D) of S. 1350, the Technical Corrections Act of 1987 as introduced by Senator Bentsen and Senator Packwood (the "TCA"), would change the reference point in Reform Act § 1433(b)(2)(C) from "date of enactment" (i.e., October 22, 1986) to "September 25, 1985." If this "technical correction" is adopted, the GST tax would apply to certain transfers by will even if the testator, because of a mental disability, became legally incapable of revising the will one year before the new GST tax was enacted. This correction is inconsistent with Congressional intent and with principles relating to retroactive changes in law and, therefore, should not be adopted.

II. Background

A. New GST Tax

The Reform Act repealed the old GST tax retroactive to its enactment and replaced it with a new one. The new GST tax is more expansive than the old tax in certain respects. For example, the new tax applies to direct transfers, by gift or will, from a grandparent to a grandchild, while the old tax did not.

Reform Act § 1433(a) provides that the new tax is generally effective for generation-skipping transfers made after the date of enactment. However, Reform Act § 1433(b)(1) states, in effect, that inter vivos transfers will be subject to the new tax if made after September 25, 1985, the date on which the Ways and Means Committee marked up and approved the new GST tax. Reform Act § 1433(b)(2) also excludes from the GST tax generation-skipping transfers under trusts that were irrevocable on September 25, 1985, and generation-skipping transfers under a will executed before the the enactment of the Reform Act if the testator died before January 1, 1987. (The TCA would expand the latter exception to apply to revocable trusts in addition to wills.)

B. Mental Disability Exception

A third exception applies to generation-skipping transfers if the transferor was, on the date of enactment, under a mental disability to change the disposition of property and did not regain competence to dispose of such property before the date of death. This rule, which is included in Reform Act § 1433(b)(2)(C), applies to:

> any generation-skipping transfer --
>
> (i) under a trust to the extent such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after the date of the enactment of [the Reform Act]), or reinvestments thereof, or
>
> (ii) which is a direct skip which occurs by reason of the death of any decedent.

The TCA would revise this exception so that it applies only if the decedent was under a mental disability on September 25, 1985. The Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) prepared by the staff of the Joint Committee on Taxation (JCS-15-87), June 15, 1987, provides no explanation for the change. It merely states:

> Finally, the bill clarifies that the decedent must have been incompetent on Septe[m]ber 25, 1985, and at all times thereafter until death, in order for direct skips or transfers of assets includible in the decedent's gross estate to be exempt from generation skipping taxes.

The mental disability exception, like the new GST tax, originated in the Ways and Means Committee. The exception in section 1223(b)(2)(B) of H.R. 3838 as reported by the Committee (and as passed by the House) is identical in every respect to the exception subsequently included in the Reform Act. However, the Ways and Means Committee report incorrectly described September 26, 1985, as the date by which the decedent was required to be mentally incompetent. See H. Rep. 426, 99th Cong., 1st Sess. 828 (1985).

The Senate bill did not include the new GST, but the Conference Committee included the new GST in the final bill. The Conference Report's description of the House bill also incorrectly stated the date by which the the House bill required the decedent to be incompetent for the mental disability exception to apply. See H. Rep. 841, 99th Cong., 2d. Sess. II-775 (1986) (the Conference Report on the Tax Reform Act of 1986, hereinafter referred to as the "Conference Report").

III. Discussion

A. The Proposed Correction Is Inconsistent with General Legislative Policy Relating to Retroactive Effective Dates.

Recently, Congress has passed many retroactive changes of law. The general principle underlying most retroactive changes is that an action by the Senate, the House, a Senate or House committee or Treasury, accompanied by notice setting a tentative effective date, puts taxpayers on notice of an impending change of law and that if a taxpayer affirmatively engages in the activity to be taxed, he may be subject to the new tax rules. In fact, in some cases the date of such action must be the effective date in order to prevent taxpayers from rushing to use loopholes before they expire. For example, after the Ways and Means Committee marked up the new GST, taxpayers who formed nontestamentary trusts under which there were generation-skipping transfers or who made gifts to grandchildren were on notice that a tax would apply to generation-skipping transfers. A retroactive effective date was needed to prevent taxpayers who wanted to make generation-skipping transfers but wanted to avoid the GST tax from rushing to make gifts to grandchildren or to set up trusts before the date of enactment. Therefore, the Reform Act grandfathers generation-skipping transfers under irrevocable trusts only if they were irrevocable as of the Committee markup on September 25, 1985, and it uses that day as the effective date for the GST tax on inter vivos transfers.

On the other hand, Congress should not expect that a taxpayer would alter or amend prior behavior based on the possibility that legislation will be enacted in the future. For example, prior to the enactment of a new tax on testamentary transfers to grandchildren, an individual has no incentive to alter his will to replace his first choice bequest to a grandchild with a second or third choice bequest (such as a bequest to charity) that would only be preferable if the proposed, new law became effective. For this reason, the Reform Act includes an exception for generation-skipping transfers under wills that were executed before the date of the enactment if the decedent died before January 1, 1987. This transition rule gave taxpayers a short period after enactment to revise their wills in response to the newly enacted legislation. (The TCA would provide a similar rule for revision of revocable trusts.)

If these general principles are applied to the mental disability rule, the GST tax ought not to apply in cases where the settlor of a trust or a testator was on December 31, 1986, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death. This would have given an individual a short window period after the date of enactment to revise the applicable instrument and provide transition relief if by reason of disability the individual was unable to do so. While not ideal, the current statutory language of the Reform Act is acceptable because it at least gave the individuals a short period, from the time Congress approved the legislation to the time the President signed it, to make changes in the applicable instruments and provides relief if such person was unable to make changes because he was mentally incompetent and remained mentally incompetent until death.

However, if the proposed technical correction is adopted, the individual would have had to have been mentally incompetent on September 25, 1985. This produces an extremely unfair result. As noted above, the new GST tax applies to certain transfers to which the old GST tax did not apply. These include very basic transfers, such as transfers directly to grandchildren by will or through trusts in which no individual from an intermediate generation had any interest. Individuals who had settled such trusts or executed such wills could not have been expected to revise them immediately following the Ways and Means Committee action in September 1985. H.R. 3838 as reported by the Ways and Means Committee on December 7, 1985, did not provide warning of an immediate need to revise wills. The bill included a date-of-enactment effective date for testamentary transfers and an exemption for mental disability that occurred prior to enactment. Even a casual observer of the legislative process in December 1985 knew that it would be no easy task to get tax reform legislation through the Senate and that legislation would not be enacted until at earliest May or June; there was substantial doubt as to whether the bill would ever be enacted. After the Senate approved a bill without a new GST tax, there was doubt as to whether the final bill, if enacted, would include a new GST tax.

If an individual failed to revise a will or trust after September 25, 1985, and then the individual became disabled, the penalty is severe. Upon his death, the transfer would be subject first to the estate tax and then to the GST tax. If instead the individual had rewritten his will or trust to name his children as beneficiaries, the second layer of tax would have been postponed until his children died. Perhaps, if the individual had been aware of double taxation, he would have given a larger portion of his estate to charity.

The mental disability exception did not require a retroactive date to prevent avoidance of the new tax. No taxpayer would intentionally become mentally incompetent in order to avoid a potential, new GST tax that may not even be enacted.

B. The Proposed Correction Is Inconsistent with Congressional Intent Relating to the Effective Dates for the New GST Tax.

There are two possible views regarding Congressional intent relating to the varying effective dates for the new GST tax, but the proposed technical correction is not consistent with either view.

1. Testamentary Versus Inter Vivos Transfers

The effective date rules reflect an effort by the draftsmen to distinguish between inter vivos transfers and testamentary transfers. The distinction and the rules are somewhat confusing because in many cases it is not the inter vivos transfer of property to a trust but some subsequent event such as the death of the settlor or a contingent beneficiary that constitutes the generation-skipping transfer. Nevertheless, the distinction has some public policy base. If a retroactive date were not used for inter vivos transfers, the Committee bill would have created a window period during which individuals would have been able to avoid the new GST by making large gifts to their grandchildren and great-grandchildren. If the earlier effective date was used primarily for inter vivos transfers, there would be no reason for moving back the required date of mental disability to September 25, 1985, because the exception applies almost exclusively to testamentary transfers (i.e., direct skips that occur by reason of death and transfers under trusts to the extent that the trust consists of property included in the gross estate of decedent).

The mental disability exception, as enacted, is generally consistent with the Reform Act's approach to testamentary transfers. The Reform Act contemplates three categories of individuals making testamentary dispositions, namely individuals who were mentally competent as of October 22, 1986 and survived until January 1, 1987, individuals who were mentally competent as of October 22, 1986, but died before January 1, 1987, and individuals who were mentally incompetent as of October 22, 1986 and failed to regain competency prior to their death. For those individuals in the first category, the Act by applying to all transfers after the date of enactment allows them to change their testamentary disposition and plan appropriately for the new GST tax rules. For those individuals in the second category, the Act recognizes that terminal illness may have prevented a timely revision of a testamentary plan and excepts them from the new rules on generation-skipping transfer tax. For individuals in the third category, the Act contemplates that they may have become mentally incompetent by October 22, 1986 and therefore were unable to revise their testamentary plans. Therefore, Reform Act § 1433(b)(2)(C) exempts the testamentary plans of such incompetent individuals from the GST tax. The TCA would penalize mentally incompetent individuals by subjecting wills of such individuals executed after September 25, 1985, to the new rules despite the fact that the individual became mentally incompetent before October 22, 1986. Such individuals would be denied a fair chance to re-execute their wills to take into account the new GST tax that covers direct skips. This conflicts with Congressional intent (relating to the exclusion for testamentary transfers by individuals who died prior to January 1, 1987), as expressed in the Conference Report:

> The conferees adopted these delays in effective dates to permit a reasonable period for individuals to re-execute their wills to conform to the extenstion of GST tax to direct skips.

The proposed technical correction fails to treat equally the three categories of individuals making testamentary dispositions by singling out the mentally incompetent individual arbitrarily for retroactive application of the new rules covering generation-skipping transfers.

2. Old GST Tax Versus New Tax

There is some language in the legislative history that suggests that delays in effective dates were needed only for generation-skipping transfers that were not covered by the old GST tax. See Conference Report at II-776. Under this interpretation of intent, the September 25, 1986, date should be used as a reference point in the mental disability transition rule only if the generation-skipping transfers to which it applies were transfers that were covered by the old GST tax. The mental disability transition rule applies in the case of two kinds of transfers, direct skips and transfers under a trust to the extent such trust includes property included in the gross estate of the decedent. A "direct skip" is an outright transfer for the benefit of a person at least two generations below the transferor or a transfer of property to a trust for one or more of such beneficiaries. The old GST tax generally did not cover direct skips which occurred by reason of death. See, for example, General Explanation of the Tax Reform Act of 1986 at 1259 (hereinafter, the "blue book"). The exception applies to some trusts under which there would have been taxable generation-skipping transfers under the old GST tax and some trusts under which there would not have been taxable transfers. Since many transfers to which the mental disability rule could apply were transfers not covered by the old GST, a September 25, 1985, date would not be consistent with a Congressional intent of using the enactment date as the point of reference for generation-skipping transfers first covered by the new GST tax. If Congress wanted to distinguish between transfers covered by the old GST and transfers not covered, the exception should require that the decedent be disabled "on the date of enactment of this Act (or, in case of transfers that would have been subject to tax under chapter 13 of the Internal Revenue Code of 1954 as in effect on the day before the date of enactment of this Act, on September 25, 1985)" and at all time thereafter prior to his death.

C. The Proposed Correction Is Not Merely Technical

The proposed correction is not merely a technical correction that inserts accidentally deleted language, corrects a cross-reference, or corrects another technical error. It would change legislative language that was clear on its face and that has stood since the Ways and Means Committee bill was printed in December 1985. The proposed change was not even listed in the original technical corrections proposal, H. Con. Res. 395, 99th Cong., 2d Sess. (1986). The "blue book" (at page 1268), which in many cases noted required technical corrections in footnotes, correctly described the exclusion as enacted and did not suggest a need for a clarification.

The real technical error with respect to the mental disability exception was made by the draftsman of the Ways and Means Committee report, which incorrectly described the exception that was included in the bill. That technical error should not lead to a technical correction of the statutory language. From a tax policy perspective, the mental disability rule as enacted makes far more sense that the rule with the proposed correction included. A technical correction should improve the law, not make it worse. The result of the proposed correction would be very substantive. It will impose a double tax that would not otherwise be imposed on parts of the estates of some individuals who became mentally disabled between September 26, 1985, and October 22, 1986.

Elimination of this technical correction will not allow taxpayers to escape tax on transfers. The draftsmen were very careful on this point; the rule applies only to transfers that are included in the taxable estate of a decedent.

IV. Conclusion

The proposed technical correction is a mistake on general equity grounds, from a tax policy perspective, and from the perspective of Congressional intent as it relates to the GST tax effective date. The proposed change is not a technical change, but is substantive change that is not required on tax policy grounds. Section 114(g)(2)(D) should be deleted from the TCA.

Submitted by:
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COMMENTS DIRECTED TO COMMITTEE ON FINANCE OF THE U.S. SENATE RELATING TO S. 1350 THE TECHNICAL CORRECTION ACT OF 1987

by: James H. Pickerell
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My comments are directed toward Code Section 263A on capitalization and inclusion in inventory costs of certain expenses.

I understand the purpose of this rule is to provide one uniform standard for capitalization of cost of all property not sold and consumed in the year in which it is produced.

On its face, this would appear to simplify the law. However, all businesses are not the same. Congress discovered, even as they were writing this section, that there were certain types of business that they had to exempt from this uniform standard because they could not capitalize their property in the manner outlined in 263A and continue to survive.

These include the farming business, the business of raising timber and ornamental trees and certain development cost for oil and gas wells and other mineral property.

I believe the "stock photography" industry will also be destroyed by this regulation and I would like to explain why.

This is a small industry, probably employing fewer than 20,000 in the United States and some of these people are part time (no accurate figures are available). The estimated gross revenue from this industry is around $400 million worldwide.

There are two basic aspects to the industry--the individual photoraphers who create the work, and the stock photo agencies who act as marketing representatives for these photographers. It is these two groups that will be most severely impacted by this Law. These photographers and agencies are also clients of other support industries such as photo labs, film manufacturers, equipment manufacturers and photo supply houses who will be impacted by whatever happens to the "stock photo" industry.

It is not widely understood what we do, thus I believe I need to explain a little of how the business works.

METHODS OF OPERATION OF PHOTOGRAPHERS WHO PRODUCE "STOCK PHOTOGRAPHS" FOR PUBLICATION

As best I can determine the business started back in the 1940's when the major picture magazines had to have photographers cover every news event in order to be sure they had photographs of the major news when it happened. At the end of each week they had an extremely high percentage of pictures they were paying for, but couldn't use because the event never developed into a major news story.

To keep their costs at a manageable level, they paid the photographer very little per day for their time. Most photographers, with exception of a few stars, found they could not afford to live on these rates.

The magazine didn't want to pay more, but they decided they could allow the photographer to use the pictures in other ways after the magazine had finished with its initial use. They also decided that if for some reason they used the pictures a second time they could afford to pay an additional fee.

On these two principles the "stock" photo industry was born. "Stock photography" is basically photography that has been produced, and is held available in file, until a user indicates that he would like to license a certain use of that picture. Most pictures have the potential of being licensed many times for non-competitive uses.

Originally, "stock photography" only resulted after pictures were first taken as part of a specific assignment by someone. However, in recent years, and particularly after the 1978 Copyright Law redefined ownership, more and more photographers have been taking pictures at their own expense of those subjects which they feel will be in demand in the future, and placing them in "stock photo" files.

The photographer assumes a giant risk here because he has to cover all the expenses of production, up front and this can run as high as several thousand dollars for some shoots. If he is going to invest this kind of money he has to have a clear understanding of the market potential for the images he is going to produce, and he has to be confident in his ability to produce the quality of images that the clients will eventually want to use and purchase.

Everyone in this business also has to deal with another great unknown. That is whether or not some competitor will produce a new set of pictures on the same subject that when compared with those produced first will make them obsolete. The client will always pick that "stock photo" that best fits his particular need. There is no loyalty by the clients to particular photographers. The business is all based on the quality of the photograph.

For this reason "stock photographers" must constantly try to improve on things they have already produced.

While this business has some obvious inefficiencies due to its competitiveness it results in better quality photographs, available to the clients, when they need them, at a price that is usually much less than what the client would have to pay for original photography.

It also makes full use of a good photograph once it is produced, rather than having to go back and do the same thing over and over again.

IMPACT ON PHOTOGRAPHERS WHO TAKE STILL PICTURES

Traditionally, still photographers have written off all costs of production in the tax year they were incurred. Traditionally, still photographers have not "sold" all rights to their work, but "licensed" usage rights.

This tax law will:

(1) Bring about a total reversal in these methods of operation.

(2) Force many photographers out of business, particularly young photographers who have little capital reserve, and who fail to restructure their metods of pricing properly.

(3) Cause those who survive to totally change their methods of doing business to avoid holding pictures in inventory, and thus avoid coming under the capitalization rule.

(4) Decrease productivity by making it uneconomic to produce "stock photography" during slow periods for assignments, or requiring tremendous amounts of paperwork for those who want to attempt to continue to shoot for the "stock photo" market.

(5) Force photographers to destroy much of the future historical record of this country in order to keep from holding it in inventory.

(6) Make it much more difficut for young people to enter the profession.

(7) Result in a greatly elevated cost of photographs for textbooks because such pictures will not be available in the stock photo market, and will have to be produced in the future as original photography. This increased production cost will undoubtedly be passed along to the textbook consumer, thus increasing the cost of education.

While doing all these negative things to the photographic industry, I predict that 263A, as written, will not raise much revenue from photographers. The additional tax that will be required as a result of this law will be so staggering, and the paperwork so impossible to maintain, that virtually all photographers will simply drop out of the "stock photo" business. They will be forced by economic realities to take only those jobs where they are paid a specific fee for doing specific work and where they turn over all rights to the client at the time of creation.

IS THERE A SOLUTION TO THIS PROBLEM IN 263A?

Congress recognized that the small retailer would have a fatal cash flow problems if he were required to capitalize all his overhead expenses. Thus, Congress provided relief for this industry with the exception in 263A(b)(2)(B).

The small independent creator of work has a similar cash flow problem and I believe that Congress meant to include these individual creators of property in the same execption. I would ask that the same or similar language to the above exception be placed under 263A(b)(1) as a matter of clarification.

PERSONAL BACKGROUND

I would like to provide you with a little personal background to establish my credentials for making this request, and explain in detail how this law will affect me.

I have been a photographer producing works for publication for over 25 years. My pictures have been published in more than 500 publictions around the world including a Life cover, and eleven covers on Newsweek. I have worked in more than eighty countries around the world on corporate and editorial assignments. I spent three and a half years covering the war in Vietnam as a freelance photo journalists and was the first American correspondent wounded in that war.

I have been active in the field of "stock photography", particularly in the past ten years. I am a recognized expert in this area of the business, and have been a speaker at many seminars on this subject.

HOW THIS LAW AFFECTS ME

Nearly all the photographs I take are used in one way or another for publication. I take pictures on specific assignment from various clients. Sometimes my arrangement with these clients is that I deliver the photos they need for their use, and I retain the "seconds" for the purpose of licensing usage rights to various other clients.

In such cases the fee the original client pays would more than cover all the "direct costs" of the project. I suspect this fee also covers all the "indirect costs" of doing the job, but I have never calculated indirect expenses on a job by job basis in that way so I can not be sure that I am not losing on some jobs and making up for them on others. I do know that I show a profit at the end of each year.

I also spend a lot of my time taking pictures specifically for the "stock photography" market. There is no guarantee that I will ever be able to license usage rights to any of these photos. As a matter of fact, more than 90% of the images I take for this market are never used.

While I cannot predict which specific images will sell and which will not, I have learned that the percentage I sell in relation to the number I have on file remains fairly constant. Therefore, the more I create and put in file, the more income I make.

I have also developed an ability, after years of experience, to choose wisely the subjects I photograph. Thus, some images from every situation I photograph will eventually sell. This would not necessarily be the case for someone learning the business because it takes time to get a thorough understanding of the market.

In the first six months of 1987 I had gross receipts from all areas of my business of $95,904.53. This breaks down into the following categories:

Income from photos in my files and those held for me by stock picture agencies. All were produced before 1987 and expensed at the time of production	$49,254.45
Gross income and reimbursed expenses from assignments where I sold all rights and where there will be no further use of the pictures beyond 1987	12,946.04
Income from other services, (lab work, computer lists, consulting, etc, which can be expensed in 1987.	4,109.51
Income from assignments where I retain some rights to use some of the pictures	29,594.53

In this six months, I spent 11.2 days taking pictures to which I sold all rights, and 34 days taking pictures where I retained some or all of the rights to the pictures.

Most people would say, "Hey, he only worked 45 days in the last six months. That's a great job. I want to get into that business." Actually, I average over 60 hours a week at my work. The rest of time over and above the 45 days spent taking pictures was spent in various administrative tasks necessary to running my business, but which do not directly contribute to income.

These include: marketing (getting new assignment business and preparing the stock photos for market), repair & maintenance, training and testing new concepts for photos, researching locations, bookkeeping and tax accounting. I view all of this time as necessary, but non-productive because no income is being produced during this time.

A fairly large portion of this time is spent keeping records for the sole purpose of being able to correctly compute my tax liability. Most of these records are of little or no other value in managing my business. I recognize the need for each individual taxpayer to be able to properly compute the tax he owes the government, but the more complex this gets, the less time the taxpayer has to do work that will produce the income on which this tax is computed.

The 1986 tax law certainly did not reduce the record keeping that will be required of photographers in order to compute their tax obligation.

As I look at the photography I have produced in the past six months, three quarters of my production time has been spent on jobs where I retained some of the rights.

This may mean that three quarters of all the expenses I had in my business in the first six months must be depreciated over the useful life of the photographs.

However, there are several questions that are not clearly answered in Section 263A or in the Income Tax Regulations (26 CFR Part 1):

1 - How do I make a realistic estimate of useful life of these photographs?

Over 90% of the images I produce for stock will never sell. I just don't know which 90%. It depends on future demand, future production of my competitors, and individual judgements by the buyers. Twenty five years in this business has taught me that there is no way for me to make judgements on future value of these photographs?

With the exception of a few very unique photographs that have been determined to be great art like the work of Ansel Adams, there is no ready market for the millions of photographs that are produced each year.

2 - Can I deduct as expenses the costs of preparation of the already created stock photo for market? This is a very

costly part of the process, without which the photographs would never have a chance of selling. Is this a part of the creation of the product, or is it a selling expense that can be deducted?

3 - How should I deal with pictures that are taken toward the end of one fiscal year, but are not used or paid for until the next fiscal year even though the general understanding at the time the picture was taken was that the client was purchasing all rights to the photograph?

4 - What about the situation where I take pictures for a client and sell all ownership rights to those pictures, but I retain the negatives on file as a convenience and service to the client in case he might want additional prints sometime in the future? Whose inventory are they in?

Let's look at how this would affect my tax picture. Assume that I can do as well in the second half of the year as I have done in the first. Then my total gross receipts would be $191,809 and my total gross expenses would be $84,692.

In the first half of the year I have sold all rights on about 25% of the projects I have worked on, and retained ownership in some, if not all the photographs, produced on the rest of the projects.

If I calculate my 1987 tax based on these figures and depreciate 75% of my expenses over a five year average useful life my tax will be more than 50% higher that it would have been were I allowed to continue to operate under the 1986 law.

I didn't expect to have no tax increase as President Reagan promised, but I didn't anticipate a 50% increase either.

STRATEGY FOR SOLVING THE PROBLEM

Obviously, such a tax increase will have serious impact on my business.

The first thing I will do is start selling all rights to the photographs I produce, and stop shooting for the "stock photo" market. Then all the expenses of production will be deductable in the year expensed as they have been in the past.

That presents a few problems because one of the reasons I got into the "stock photo" market in the first place was that it was a way to increase my productivity when I couldn't get enough assignment work to keep myself busy and make a decent living.

At this point in my career, I may be in a better position to get assignment work than I was before. The same will not hold true for the young people who have just entered the profession in the last few years.

I may continue to put a few selected photos a year into the stock photo market and depreciate the direct costs and the overhead costs for these photos.

However, I will not be able to supply them to the stock photo agencies consistantly throughout the year. It will be necessary to wait until December of each year before I can determine actual costs of each set of photographs and which ones, if any, that I have produced during the year are the best candidates for the stock photo market.

I know what the direct costs of these photos are, but it will be the indirect costs which will be the more severe strain, and I have no realistic way of even estimating that cost until near the end of the year when I have some idea of the kind of assignments I have had over the year, the quality of the images produced and which ones have the best potential for the stock market. Those of lesser quality will have to be destroyed. If I do that then I will have received 100% of the income from these images in the year they were produced and thus, I can deduct 100% of the expenses.

For many businesses this would not be a problem or a consideration. They would simply go out and borrow the money to pay the additional tax recognizing that down the road the money would be coming back as they get additional depreciation in future years.

Most photographers don't have that option. We are not producing a product that has a recognized market value. The product only has value when potential user agrees to pay a fee to use the image. No banker will loan a dime on this kind of collateral. For most photographers the only access to capital is profit from previous jobs.

The younger, less experienced photographers--those on their way up--will not have the same options I have. If they are to build a file that will produce income in future years they will have to invest a much higher percentage of their capital than I do in producing pictures for the files. However it is unlikely that they will have the capital available to do this. Because of this, I predict that the business of "stock photography" will atrophy and die as a result of this law.

This law will also cause much of our future art heritage and historical record to be destroyed because no one will be able to afford to hold it in inventory.

To amplify this point, let me detail one specific example that occurred with my work.

Early in my career as a photographer I spent three-and-a-half years covering the war in Vietnam.

During this period my work was used in most of the major news magazines of the world and I retained ownership to the majority of the photographs I produced. The expenses I incurred were totally written off against my tax obligation in the year in which they were incurred.

But let us assume for the moment that 263A had been the law and the somehow I could have afforded to depreciate these photos over their useful life. As it turned out within a year or two after I had taken these pictures there was little demand for them.

Users at first wanted the new, more dramatic photos that were being produced every day. Then there came a time when the U.S. left the war and you couldn't give a Vietnam photograph away. Nobody wanted to talk or hear about Vietnam.

If I had been operating under the present tax law at that time, I would have had a difficult decision to make as a businessman. Do I destroy this work, thus removing it from inventory so I can take the total write off and use the money to get on with creating other income producing product, or do I retain it for its historical value at great personal cost to me?

As it turned out ten years after the war and more than fifteen years after I had produced most of my photographs there was a revival of interest in analyzing the war. There was a demand for my photographs for books being produced as a historical record. They were also used in museum exhibits to help raise the consciousness of those who would view these exhibits.

I made a significant amount of income off of those pictures at that point on which I paid tax.

Under the rules of this bill undoubtedly those pictures would have been destroyed because it didn't make good economic sense to retain them.

Another area where I license the use of a lot of stock photos is the textbook market. Textbooks are one of the largest users of "stock photography". In my judgement, this law will have a serious impact on this market.

I would estimate that over 90% of the photographs presently used in textbooks are stock photographs. Almost all of these photos were originally shot for some other purpose. The textbook producers make very few assignments because they can not afford fees that are even close to normal assignment rates for the pictures they need.

If "stock photographs" are no longer available to them, they will have to make assignments and I'm sure the additional costs of production will result in more expensive textbooks. This will bring in tax revenue, but from an unexpected source. I would ask you to consider whether it is in the best interest of the country to increase the cost of education.

SUMMARY OF COMMENTS BY JAMES PICKERELL

In the Tax Reform Act of 1986, Section 263A(b) capitalization of all the expenses incurred in the production of "tangible personal property" is required. An exception was given for the resellers of such property, but not for producers.

PROBLEMS FOR STILL PHOTOGRAPHERS TRYING TO COMPLY WITH THE LAW

Many still photographers create photographs on speculation for what is known in the industry as the "stock photo market". At the time of creation it is impossible to predict the long range value of the photograph or "product". It is also impossible to predict useful life with any sense of certainty.

Traditionally, photographers have leased rights to use their photographs, rather than selling them outright. Thus, even when there is a license to use the work it is impossible to determine what percent of the total value has been paid for.

Consequently, all of the elements for developing a depreciation schedule are missing. Whenever a fee is paid to license the usage of a photograph there is no way to predict what percentage of the total lifetime value of the photograph has been licensed. It may be 100%, or it may be a small fraction of a percent. The photographer will only be able to answer the question of what the percent was when the photograph is finally destroyed or removed from inventory.

Thus, under the present law the photographer can never deduct any of the costs of production unless he totally changes his methods of operation and sells all rights in his creation to a third party.

IMPACT ON PHOTOGRAPHERS WHO TAKE STILL PICTURES

Traditionally, still photographers have written off all production expenses, in the tax year they were incurred.

This tax increase will:

(1) Force many photographers out of business.

(2) Cause those who survive to totally change their methods of doing business to avoid holding pictures in inventory, and thus avoid coming under the capitalization rule.

(3) Decrease productivity.

(4) Force photographers to destroy much of the future historical record of this country in order to keep from holding it in inventory.

(5) Make it much more difficut for young people to enter the profession.

(6) Result in a greatly elevated cost of photographs for textbooks thus increasing the cost of education.

RECOMMENDED CORRECTION

I believe it was the intent of Congress to provide the same protection for the small individual creator as they provided for the small reseller. This can be accomplished by putting the same or similar language found in 263A(b)(2)(B) under 263A(b)(1).

TESTIMONY OF

MR. JOE FAKER
PRESIDENT
PORT OF TACOMA COMMISSION
TACOMA, WASHINGTON

SUBMITTED TO THE
TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE
OF THE
SENATE FINANCE COMMITTEE

JULY 22,1987

Mr. Chairman, as your subcommittee reviews possible technical corrections to tax legislation enacted during the 99th Congress, the Port of Tacoma, Washington urges you to address an unintended inequity in the implementation of the .04 percent harbor maintenance fee authorized by the Water Resources Development Act of 1986 (P.L. 99-662).

Congress enacted the harbor maintenance fee to finance some of the costs of operating and maintaining U.S. ports and waterways. On March 30, the U.S. Customs Service issued interim regulations implementing this tax, which took effect on April 1. These regulations permit multiple taxation of import and export cargoes that are discharged at a U.S. port for waterborne conveyance to another U.S. port. We believe that this decision is inconsistent with the principles of the fee and constitutes poor transportation policy.

Congress established a single Harbor Maintenance Trust Fund to help finance improvements to the national navigation system. Congress did not establish separate trust funds for each waterway. The triggering event for tax assessment is the use of the navigable waters of the United States, which occurs only once.

Congress recognized the equitable principle of single taxation when it provided that domestic cargoes should be assessed only once, and when it provided that cargo should not be taxed twice when it is taken off and put back on the same vessel at a U.S. port. Permitting multiple taxation only of export or import cargoes which are taken off one vessel and transferred to another vessel for shipment to another U.S. port is inconsistent with the equitable principle of single taxation recognized in the Water Resources Act.

The multiple taxation permitted by the Customs regulations also threatens to disrupt this nation's current efficient system of load-center ports, which serve a function like those of airline hubs. Modern steamship lines have developed a system whereby cargoes are funneled through large load-center ports, and relayed to and from smaller U.S. ports by less expensive ships and barges, and to and from inland points on trains and trucks. Hundreds of millions of dollars have been invested in the development of these sophisticated, centralized load-center facilities.

Multiple taxation discourages this economical practice and increases the demand for scarce federal funds for developing more large, deep-draft ports. Such a change in U.S. transportation policy is not only unwise, but also apparently unintended by Congress.

The Port of Tacoma is particularly concerned about this issue because we handle approximately 65 percent of the waterborne commerce between Alaska and the U.S. mainland. Sea-Land and other steamship lines have established an efficient system of transporting goods between Alaska and Tacoma by barge and between Tacoma and the Far East by large containerships. Taxing those goods at both Tacoma and Alaskan ports will inevitably raise the cost of those goods to Alaskan consumers and Asian importers of Alaskan products.

We believe, Mr. Chairman, that the multiple taxation of a limited category of waterborne cargoes is an inconsistent and unfair policy which threatens to disrupt an innovative and efficient portion of our national transportation system. The Port of Tacoma urges you and your subcommittee to support a clarifying amendment on multiple taxation as a part of the Technical Corrections Act of 1987.

Thank you for your consideration of our views.

STATEMENT OF POTLATCH CORPORATION
SAN FRANCISCO, CALIFORNIA

ON S. 1350, THE TECHNICAL CORRECTIONS ACT OF 1987

The Potlatch Corporation (the "Company") owns and operates forest products manufacturing facilities in the South, Midwest and Western United States. Its main product lines are solid wood products, such as lumber, plywood and oriented strand board, and pulp-based products, such as paperboard, printing papers and consumer tissue. The Company has sought to remain competitive in its operating areas through modernization programs which have involved substantial capital investments over recent years. These capital investment projects have been assisted by the investment tax credit, which was repealed last year. The Company respectfully requests that the Committee extend transition relief from the repeal of the investment tax credit to two projects it undertook prior to January 1, 1986 in reasonable reliance on prior law.

BACKGROUND

The Tax Reform Act of 1986 (Pub. L. No. 99-514) (the "Act") generally repeals the investment tax credit for qualified property that was placed in service after December 31, 1985. The Act provides transition relief in certain circumstances, however. Under section 211(a) of the Act, the investment tax credit remains available for transition property, that is, property to which the depreciation changes made by the Act do not apply. Generally, transition property is property constructed, reconstructed or acquired by the taxpayer pursuant to a written contract that was binding as of December 31, 1985, or for self-constructed property, if the taxpayer had (i) incurred or committed by December 31, 1985 the lesser of $1 million or 5 percent of the cost of the property and (ii) begun construction or reconstruction of the property by that date. In addition, if the class life of the property is at least seven but less than twenty years, then the property must be placed in service no later than January 1, 1989.

Section 204(a)(5) of the Act, however, also treats as transition property certain projects that were part of a master plan. Several forest products mill projects with circumstances similar to the projects under development by Potlatch are enumerated in that subsection. See section 204(a)(5)(K) of the Act. Projects receiving transition relief include:

- a super calendered paper mill in Duluth, Minnesota;
- a paper mill for the manufacture of newsprint;
- modernization of pulp and paper mills located in Millinocket and/or East Millinocket, Maine;
- installation of a paper machine for production of coated publication papers, modernization of a pulp mill, and installation of machinery and equipment with respect to related processes located in Pine Bluff, Arkansas; and
- property included in a paper plant located in Effingham County, Georgia.

Furthermore, section 102(d)(26) of S. 1350, the Technical Corrections Act of 1987 (the "bill"), would exempt the following additional projects that are also similar to the projects under development by Potlatch:

- a wood resource complex; and
- a facility for the manufacture of an improved particleboard in North Carolina.

In substantial reliance on prior law, Potlatch undertook two projects similar to the projects granted transition relief in section 204(a)(5)(K) of the Act, and to the projects proposed for relief in section 102(d)(26) of the bill.

Cloquet, Minnesota Project

The Company decided in 1977 to update the machinery in its mill in Cloquet, Minnesota. The Company spent more than $1.4 million in engineering, design, planning and other costs prior to December 31, 1985 to develop exact specifications of a paper machine and coater and to design the structure in which such equipment would be housed. Nine employees were assigned full-time during 1985 to plan and execute the project. By December 31, 1985, all detailed planning and soil boring had been completed and firm bids had been obtained for the purchase of the major equipment.

The Board of Directors approved the project in principle on December 12, 1985. Only an unforeseen takeover attempt against the Company in November, which led to a substantial immediate reduction in the Company's liquid assets, prevented complete project funding in December 1985. On February 21, 1986, the Board committed the funds to complete the first stage of the expansion, which included the entire housing structure and the paper machine.

Property from the first stage will be put in service by the first quarter of 1988. All remaining property in the Company's master plan for Minnesota will be in service by the final quarter of 1988 or the first quarter of 1989.

Lewiston, Idaho Project

Over $1 million was incurred by the Company by December 31, 1985 in engineering, design, planning, equipment and other costs in the replacement of the Company's Lewiston, Idaho sawmill. Although Board approval of complete funding for the project was scheduled for September 1985, economic conditions forced a delay. The mill temporarily shut down. In November 1985 the Company entered into a supplemental labor contract that committed the Company to reopen the plant and to proceed with its rebuilding. Funding approval became infeasible in December 1985 because of the takeover attempt mentioned above. Final funding approval by the Board came on May 2, 1986. Shortly after, construction bid packages were sent out and construction work started in early 1987. The property is scheduled to be placed in service in the final quarter of 1987 or the first quarter of 1988.

The forest products industry experienced serious economic decline in the early to mid-1980's. Hard hit by the drop in demand, investment decisions were delayed In providing relief to other forest products manufacturers in section 204(a)(5)(K), Congress recognized the special needs of these firms. The Company believes that, had Congress been aware of the Company's two projects, it would have included them in the list of property at other forest products mills that received special transition rules. Like the property at those other mills, Potlatch's property was part of a master plan for development for which significant expenditures had been incurred prior to December 31, 1985. Moreover, transition rules that cover only certain projects, but not others similarly situated, foster the perception of inequity in the tax laws and actually create a situation where one company has an unfair competitive advantage in the marketplace. In the case of the forest products industry, the failure to develop a generic rule has given the companies whose projects are named in the statute that unfair advantage. The Company asks the Committee only for the same treatment for these two projects that firms similarly situated received in the Act.

POTLATCH CORPORATION
July 17, 1987

Presbyterian Healthcare Foundation
Post Office Box 26666
Albuquerque, New Mexico 87125-6666

July 17, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

The purpose of my letter is to request that the Senate Committee on Finance consider an amendment to the Technical Corrections Bill (S. 1350) to provide that charitable gift annuities not be subject to IRS Section 501(m).

Presbyterian Hospital in Albuquerque, New Mexico began a charitable gift annuity program in the 1920s when this hospital was a tuberculosis sanitorium. While the gift annuity program is not a major source of contributed funds for our hospital, we feel it is an important program to preserve. It allows people who cannot make large contributions to our hospital to have the advantages of a life income arrangement without the expense of setting up a trust, which would not be cost effective for a relatively small gift.

The basic purpose of the charitable gift annuity is to provide the hospital or other charity with a gift. The annuity payment to the individual is not as high as he could receive if he bought a commercial annuity. Therefore, it seems appropriate that the charitable gift annuity not be categorized in the same way as commercial annuities.

Thank you very much for your consideration of this request.

Sincerely,

Mary Poole

Mary D. Poole
Executive Vice President

MDP:as

LAW OFFICES OF
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MEMORANDUM

TO: Senate Finance Committee

FROM: Preston, Thorgrimson, Ellis & Holman

DATE: July 22, 1987

RE: Technical Corrections Act; Limitation on Elective Deferrals under 403(b) Tax Deferred Annuity

---

Section 402(g)* of the Internal Revenue Code of 1986 (the "Code"), as added by Section 1105(a) of the Tax Reform Act of 1986 (the "Act"), imposes a $9,500 limit on "elective deferrals," including:

> "...any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D))." (Code § 402(g)(3)(C).)

Under this Code language, __all__ contributions made by salary reduction agreement (including those made as a condition of employment) are subject to the $9,500 limit.

The Conference Committee Report on the Act (the "Report"), which has the effect of law since it is part of the official legislative history of the Act, contains the following:

> "...[I]f an employee is required to contribute a fixed percentage of compensation to a tax-sheltered annuity as a condition of employment, the contributions are not treated as elective deferrals."

* Note: There are __three__ Code Sections 402(g) after amendments made by the Tax Reform Act of 1986.

The language of the Report reflects a legislative intent that is contrary to the inclusive language used in the Act. The legislative intent appears to have been to distinguish between "elective" and "required" employee contributions, the latter (whether pre-tax or after-tax) being more of the nature of an employer contribution since the employee is given no choice but to contribute part of his/her compensation. The "Blue Book" (Joint Committee Explanation of the Act) does not clarify the effect of the $9,500 limit on an employee who is required to contribute a fixed percentage of compensation to an annuity contract as a condition of employment. Therefore, it is impossible to advise clients concerning the application of the limits on such an employee's contributions.

We ask that the inconsistency between the Report and the Act be remedied by codifying the language from the Report in the form of an amended Code section 402(g)(3)(C)* in the Technical Corrections Act as follows:

> "(C) any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D) <u>except to the extent the employee is required to contribute a fixed percentage of compensation to an annuity contract as a condition of employment</u>."

Since this additional language would simply incorporate the original congressional intent, as expressed in the Report, no revenue impact would result from this additional language.

* Note: There are <u>three</u> Code Sections 402(g) after amendments made by the Tax Reform Act of 1986.

For your convenience, we attach:

(1) Relevant sections of the Report;

(2) Relevant section of the Act;

(3) Relevant section of the "Blue Book"; and

(4) Legislative Language for Technical Corrections Act.

tions and State and local governments (or a political subdivision of a State or local government) from establishing qualified cash or deferred arrangements is adopted.

The conference agreement provides that this provision does not apply to plans adopted before (1) May 6, 1986, in the case of an arrangement maintained by a State or local government (or political subdivision of a State or local government), or (2) July 2, 1986, in the case of an arrangement maintained by a tax-exempt organization. The grandfather treatment is limited to the employers who adopted the plan before the dates specified above. However, the grandfather treatment is not limited to employees (or classes of employees) covered by the plan as of the date the grandfather treatment is provided.

The provision is effective for years beginning after December 31, 1986. However, in the case of a plan maintained by a State or local government that was adopted before May 6, 1986 (and is, therefore, eligible for the grandfather rule), the following provisions in the conference agreement applicable to qualified cash or deferred arrangements do not apply until years beginning after December 31, 1988: (1) the modification of the special nondiscrimination tests, (2) the new definition of highly compensated employees, (3) the new definition of compensation, and (4) the rule aggregating highly compensated employees.

Definitiod of compensation

The conference agreement adopts a uniform definition of compensation for purposes of applying the special nondiscrimination requirements, effective for years beginning after December 31, 1988. [*See* ¶ 8114.]

[*Tax-Sheltered Annuities*]

[House Committee Report]

Elective Contributions Under Tax-Sheltered Annuities

Limit on elective deferrals

Under the bill, the maximum amount that an employee can elect to defer for any taxable year under all tax-sheltered annuities in which the employee participates is limited to $7,000 [The Conference Bill raises the amount for tax-sheltered 403(b) annuities]. Whether or not an employee has deferred more than $7,000 a year is determined without regard to any community property laws. In addition, the $7,000 limit is coordinated with elective 401(k) deferrals and the annual deduction limit for IRA contributions.

Unlike the overall limits on annual additions, which apply separately to amounts accumulated under plans of different employers, this $7,000 cap limits all elective deferrals by an employee. Thus, the $7,000 limit applies to aggregate deferrals made under all tax-sheltered annuity programs and cash or deferred arrangements in which the employee participates. [The Conference Bill clarifies the definition of elective deferrals.]

Because this $7,000 limit applies only to elective deferrals, each employer may make additional contributions on behalf of any employee to the extent that such contributions, when aggregated with elective deferrals made by the employee under that employer's tax-sheltered annuity during the limitation year, do not exceed the exclusion allowance or the overall limits on contributions and benefits.

If, in any taxable year, the total amount of elective deferrals contributed on behalf of an employee to any tax-sheltered annuities and qualified cash or deferred arrangements in which the employee participates exceeds $7,000, then the amount in excess of $7,000 (the excess deferrals) [is] included in the employee's gross income for the year. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the tax-sheltered annuities in which the employee participates and notify the administrator of each program of the portion of the excess deferrals allocated to it. Further, not later than April 15 after the close of the employee's taxable year, each program is to distribute to the employee the amount of the excess deferrals (plus income attributable to the excess) allocated to the plan. This distribution of excess deferrals may be made notwithstanding any other provision of law.

The committee intends that the tax-sheltered annuities maintained by any single employer should preclude an employee from making elective deferrals under the program for any taxable year in excess of $7,000.

The amount of excess deferrals distributed to an employee (plus the income on the excess deferrals) [is] included in the employee's income for the year to which the excess deferrals relate. However, the amounts are treated as if they had not been contributed to the tax-sheltered annuity program and, therefore, are not subject to any additional income taxes for early withdrawals.

Excess deferrals that are not distributed by the applicable April 15 date are not treated as employee contributions upon subsequent distribution even though such deferrals had been included in the employee's income.

Special catch up election

Finally, the bill provides an exception to the $7,000 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the overall limit on contributions and benefits (sec. 415) in the case of employees of an educational organization, a hospital, a home health service agency, or a church, convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions.

(1) In no year can the additional contributions be more than $3,000;

(2) An aggregate limit of $15,000 applies to the total amount of contributions that, in any year, exceed $7,000; and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service that the individual performed with the employer.

Effective Dates

The provisions generally are effective for years beginning after December 31, [1986]. A special effective date is provided in the case of a tax-sheltered annuity program maintained pursuant to one or more collective bargaining agreements ratified before [March 1, 1986], between employee representatives and one or more employers. Under this special rule, the provisions do not apply to contributions made under such an agreement in taxable years beginning before the earlier of (1) the date or which the last of the collective bargaining agreements terminates or (2) January 1, [1989].

[Conference Committee Report]

Elective Contributions Under Tax-Sheltered Annuities

Limit on elective deferrals

The conference agreement follows the House bill, except that the annual limit on elective deferrals under a tax-sheltered annuity is increased to $9,500. The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

' The conference agreement clarifies the definition of elective deferrals to which the annual limit applies. In the case of an employer that allows employees a one-time election to participate in a contributory defined benefit pension plan with a single mandatory contribution rate or a tax-sheltered annuity program with elective deferrals, neither the election of an employee to participate in the defined benefit plan nor the employee contributions made to the defined benefit plan are to be treated as elective deferrals for purposes of the annual limit. Similarly, if an employee is required to contribute a fixed percentage of compensation to a tax-sheltered annuity as a condition of employment, the contributions are not treated as elective deferrals. This is considered elective deferrals if the employer and employee enter into temporary employment contracts. The conferees do not intend these examples to constitute the only situations in which contributions are not treated as elective deferrals. The conferees direct the Secretary to provide guidance to employers on other contributions that are not to be treated as elective deferrals.

Special catch-up election

The conference agreement follows the House bill and extends the special catch-up election to employees of health and welfare service agencies.

Effective dates

The provisions are effective for taxable years beginning after December 31, 1986.

A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under this special rule, with respect to employees covered under a plan maintained pursuant to a collective bargaining agreement between employee representatives and one or more employers ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) January 1, 1989, or (2) the date on which the last of the collective bargaining agreement[s] terminates (determined without regard to any extensions in the collective bargaining agreement).

(ii) is treated as long-term capital gain under subsection (a)(2) of this section or section 403(a)(2).

(D) Vesting.—For purposes of this paragraph the term "vesting" means the portion of the accrued benefits derived from employer contributions to which the participant has a nonforfeitable right.

[CCH Explanation at ¶127, 670, 688, 700 and 718. Committee Report at ¶7104, 8108, 8122, 8852 and 8888.]

(f) WRITTEN EXPLANATION TO RECIPIENTS OF DISTRIBUTIONS ELIGIBLE FOR ROLLOVER TREATMENT.—

(1) In General.—The plan administrator of any plan shall, when making a[n] eligible rollover distribution, provide a written explanation to the recipient—

• • •

(2) Definitions.—For purposes of this subsection—

(A) Eligible Rollover Distribution.—The term "eligible rollover distribution" means any distribution any portion of which may be excluded from gross income under subsection (a)(5) of this section or subsection (a)(4) of section 403 if transferred to an eligible retirement plan in accordance with the requirements of such subsection.

(B) Eligible Retirement Plan.—The term "eligible retirement plan" has the meaning given such term by subsection (a)(5)(E)(iv).

[CCH Explanation at ¶724. Committee Report at ¶8888.]

→ Caution: Code Sec. 402(g), below, as added by Act Sec. 1852(b)(3)(A), is effective as if included in P.L. 98-369. ←

(g) TREATMENT OF SELF-EMPLOYED INDIVIDUALS.—For purposes of this section, except as otherwise provided in subparagraph (A) of subsection (e)(4), the term "employee" includes a self-employed individual (as defined in section 401(c)(1)(B)) and the employer of such individual shall be the person treated as his employer under section 401(c)(4).

→ Caution: Code Sec. 402(g), below, as added by Act Sec. 1854(f)(2), applies generally to any transaction occurring after 1984. ←

(g) EFFECT OF DISPOSITION OF STOCK BY PLAN ON NET UNREALIZED APPRECIATION.—

(1) In General.—For purposes of subsection (a)(1) or (e)(4)(J), in the case of any transaction to which this subsection applies, the determination of net unrealized appreciation shall be made without regard to such transaction.

(2) Transaction to Which Subsection Applies.—This subsection shall apply to any transaction in which—

(A) the plan trustee exchanges the plan's securities of the employer corporation for other such securities, or

(B) the plan trustee disposes of securities of the employer corporation and uses the proceeds of such disposition to acquire securities of the employer corporation within 90 days (or such longer period as the Secretary may prescribe), except that this subparagraph shall not apply to any employee with respect to whom a distribution of money was made during the period after such disposition and before such acquisition.

→ Caution: Code Sec. 402(g), below, as added by Act Sec. 1105(a), applies generally after 1986. ←

(g) LIMITATION ON EXCLUSION FOR ELECTIVE DEFERRALS.—

(1) In General.—Notwithstanding subsections (a)(8) and (h)(1)(B), the elective deferrals of any individual for any taxable year shall be included in such individual's gross income to the extent the amount of such deferrals for the taxable year exceeds $7,000.

(2) Required Distribution of Excess Deferrals.—

(A) In General.—If any amount (hereinafter in this paragraph referred to as "excess deferrals") is included in the gross income of an individual under paragraph (1) for any taxable year—

(i) not later than the 1st March 1 following the close of the taxable year, the individual may allocate the amount of such excess deferrals among the plans under which the deferrals were made and may notify each such plan of the portion allocated to it, and

(ii) not later than the 1st April 15 following the close of the taxable year, each such plan may distribute to the individual the amount allocated to it under clause (i) (and any income allocable to such amount).

The distribution described in clause (ii) may be made notwithstanding any other provision of law.

(B) Treatment of Distribution Under Section 401(k).—Except to the extent provided under rules prescribed by the Secretary, notwithstanding the distribution of any portion of an excess deferral from a plan under subparagraph (A)(ii), such portion shall, for purposes of applying section 401(k)(3)(A)(ii), be treated as an employer contribution.

(C) Taxation of Distribution.—In the case of a distribution to which subparagraph (A) applies—

(i) except as provided in clause (ii), such distribution shall not be included in gross income (and no tax shall be imposed under section 72(t)), and

(ii) any income on the excess deferral shall, for purposes of this chapter, be treated as earned and received in the taxable year in which such excess deferral is made.

(3) Elective Deferrals.—For purposes of this paragraph, the term "elective deferrals" means, with respect to any taxable year, the sum of—

(A) any employer contribution under a qualified cash or deferred arrangement (as defined in section 401(k)) to the extent not includible in gross income for the taxable year under subsection (a)(8) (determined without regard to this subsection),

(B) any employer contribution to the extent not includible in gross income for the taxable year under subsection (h)(1)(B) (determined without regard to this subsection), and

(C) any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)).

(4) Increase in Limit for Amounts Contributed Under Section 403(b) Contracts.—The limitation under paragraph (1) shall be increased (but not to an amount in excess of $9,500) by the amount of any employer contributions for the taxable year described in paragraph (3)(C).

(5) Cost-of-Living Adjustment.—The Secretary shall adjust the $7,000 amount under paragraph (1) at the same time and in the same manner as under section 415(d).

(6) Disregard of Community Property Laws.—This subsection shall be applied without regard to community property laws.

(7) Coordination with Section 72.—For purposes of applying section 72, any amount includible in gross income for any taxable year under this subsection but which is not distributed from the plan during such taxable year shall not be treated as investment in the contract.

(8) Special Rule for Certain Organizations.—

(A) In General.—In the case of a qualified employee of a qualified organization, with respect to employer contributions described in paragraph (3)(C) made by such organization, the limitation of paragraph (1) for any taxable year shall be increased by whichever of the following is the least:

(i) $3,000,

(ii) $15,000 reduced by amounts not included in gross income for prior taxable years by reason of this paragraph, or

(iii) the excess of $5,000 multiplied by the number of years of service of the employee with the qualified organization over the employer contributions described in paragraph (3) made by the organization on behalf of such employee for prior taxable years.

(B) Qualified Organization.—For purposes of this paragraph, the term "qualified organization" means any educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches. Such term includes any organization described in section 414(e)(3)(B)(ii). Terms used in this subparagraph shall have the same meaning as when used in section 415(c)(4).

(C) Qualified Employee.—For purposes of this paragraph, the term "qualified employee" means any employee who has completed 15 years of service with the qualified organization.

essary to ensure that employees have equal access to tax-sheltered annuities through salary reduction agreements.

Explanation of Provisions

Limit on elective deferrals

The Act imposes a limit on elective deferrals under a tax-sheltered annuity which operates in the same manner as the limit on elective deferrals under a qualified cash or deferred arrangement. However, the annual limit on elective deferrals under a tax-sheltered annuity is $9,500 rather than $7,000. The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

Elective deferrals under a tax-sheltered annuity program consist of those employer contributions made pursuant to a salary reduction agreement, whether evidenced by a written instrument or otherwise (sec. 3121(a)(5)(D)), to the extent those contributions are excludable from the employee's gross income. If, however, an employee has a one-time election to participate in a program that requires a pre-tax contribution (or a post-tax employee contribution in lieu of a pre-tax contribution) as a condition of participation, such contribution will not be considered an elective deferral to the extent that the employee is not permitted subsequently to modify the election in any manner (including modifying the election to make post-tax contributions rather than pre-tax contributions). In addition, the Secretary is authorized to prescribe additional instances in which pre-tax contributions to a plan will not be considered elective despite the existence of limited rights of election by the employee.

If an employee has made more than 1 election, it is presumed that pre-tax contributions subject to the elections are elective deferrals. The presumption can only be rebutted by evidence demonstrating that a subsequent election was made following a bona fide separation from service, and not a temporary absence.

Special catch-up election

The Act provides an exception to the $9,500 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additional salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000 (and, therefore, the $9,500 limit may not be increased above $12,500);

(2) An aggregate, lifetime limit of $15,000 applies to the total amount of catch-up contributions (i.e., contributions that, in any year, exceed the limit on elective deferrals for that year); and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service (within the meaning of sec. 403(b))[26] that the individual performed with the employer.

Further, it is intended that the definition of years of service for purposes of the special catchup election will include principles similar to the principles of section 414(a). For this purpose, an employee's years of service will be determined by including all years of service with a predecessor employer (within the meaning of sec. 414(a)). Thus, years of service with a denomination of a church that merges into or combines with another denomination generally are to be aggregated with years of service with the surviving denomination.

Because employers may not have records for prior years with respect to the portion of contributions to tax-sheltered annuities that were elective deferrals, it may be difficult for employers to calculate the lifetime limit for an employee. It is expected that the Secretary will provide administrable methods that employers can use to calculate elective deferrals for prior years.

Effective Dates

The provisions are effective for taxable years beginning after December 31, 1986. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Revenue Effect

This provision and the provisions discussed in 2., 3., and 4., of this Part A are estimated to increase fiscal year budget receipts by $310 million in 1987, $628 million in 1988, $691 million in 1989, $809 million in 1990, and $924 million in 1991.

7. Special rules for simplified employee pensions (sec. 1108 of the Act and sec. 408(k) of the Code)[27]

Prior Law

Under prior and present law, if an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit is increased to the lesser of $30,000 or 15 percent of compensation. Under prior law, the increased deduction limit applied only to employer contributions made on behalf of an employee to the SEP on a nonelective basis.

[26] A technical correction may be needed so that the statute reflects this intent.

[27] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1209; S.Rep. 99-313, pp. 609-612; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 406-408 (Conference Report).

Legislative Language for
Technical Corrections Act

Internal Revenue Code Section 402(g)(3)(C)*, as added by Section 1105(a) of the Tax Reform Act of 1986, is amended to read as follows:

"(C) any employer contribution to purchase an annuity contract under section 403(b) under a salary reduction agreement (within the meaning of section 3121(a)(5)(D)) <u>except to the extent the employee is required to contribute a fixed percentage of compensation to an annuity contract as a condition of employment.</u>"

* Note: There are <u>three</u> Code Sections 402(g) after amendments made by the Tax Reform Act of 1986.

PROPOSED CLARIFICATION
TO CORPORATE ALTERNATIVE MINIMUM TAX

Section 701(a) of the Tax Reform Act of 1986 amends Part VI of subchapter A of chapter 1 of the Internal Revenue Code (IRC) to impose an alternative minimum tax (AMT) for individuals and corporations. As amended, IRC section 56(g) provides that the alternative minimum taxable income (AMTI) of any corporation for any taxable year beginning after 1989 shall be adjusted based on "adjusted current earnings."

Pursuant to IRC section 56(g)(3), the term "adjusted current earnings" means:

> "the AMTI for the taxable year --
>
> (A) determined with the adjustments provided in paragraph (4), and
>
> (B) determined without regard to this subsection and the alternative tax net operating loss deduction."

IRC section 56(g)(4) provides a number of adjustments in determining adjusted current earnings. Included among those adjustments is IRC section 56(g)(4)(A)(i), which states (emphasis added):

> "PROPERTY PLACED IN SERVICE AFTER 1989. -- The depreciation deduction with respect to any property placed in service in a taxable year beginning after 1989 shall be determined under whichever of the following methods yields deductions with a smaller present value:
>
> (I) The alternative system of section 168(g), or
>
> (II) **The method used for book purposes.**"

In addition, IRC section 56(g)(4)(A)(v) states (emphasis added):

> "(v) SLOWER METHOD USED IF USED FOR BOOK PURPOSES. -- In the case of any property to which clause (ii), (iii), or (iv) applies, if the depreciation method used for book purposes yields deductions for taxable years beginning after 1989 with a smaller present value than the method which would otherwise be used under such clause, **the method used for book purposes shall be used in lieu of the method which would otherwise be used under such clause.**

The statute does not address the situation of a lessor who for financial-statement purposes is required by Financial Accounting Standard Number 13 (FAS 13) to account for leases as direct-financing leases, but for tax purposes, properly accounts for leases as operating leases. Pursuant to FAS 13, no depreciation *per se* is deducted for financial purposes, while for tax purposes depreciation is deducted.

The language of IRC section 56(g)(4)(A) could be interpreted to say that since no depreciation is deducted for book purposes, no depreciation deduction would be allowed for AMT purposes in the above situation. It should be noted that this interpretation would apply regardless of when the asset was placed in service; i.e., it would be applicable for taxable years beginning after 1989 for assets placed in service both before or after 1989.

It also could be interpreted that since there is no depreciation method for book purposes, IRC sections 56(g)(4)(A)(i)(II) and 56(g)(4)(A)(v) are not applicable. If so, other provisions within IRC section 56(g)(4)(A) would apply. For example, pursuant to IRC section 56(g)(4)(A)(i)(I), property placed in service after 1989 would be depreciated under the alternative system of IRC section 168(g) if the book method is not applicable. Finally, it could be interpreted that although the FAS 13 accounting for direct-finance leases does not result in a depreciation deduction _per se_, the asset is effectively written down by operation of the required journal entries, and therefore, a "deemed" depreciation should be allowed.

Briefly, under the direct financing method, FAS 13 requires the lessor to substitute a "lease receivable" for the leased asset. The amount of the "lease receivable" is the sum of the lease payments receivable over the term of the lease, plus the estimated residual value of the leased asset.

The difference between the "lease receivable" and the cost or carrying value of the property is recorded as unearned income. As lease payments are received, the lease receivable is written down and the unearned income is amortized to income.

Upon expiration of the lease, the lease receivable would be written down to the estimated residual value and the unearned income would be fully written off. Thus, although the lessor records no depreciation expense, the asset is effectively written down from its original cost or carrying value to its residual value. One could argue that this represents a depreciation method.

For the reasons stated above, a clarification is needed to provide a rule applicable to financing lease transactions for purposes of permitting taxpayers to calculate depreciation under the adjusted current earnings rule. We believe that there are several options available to you for providing a technical correction.

Option 1: Indicate that IRC sections 56(g)(A)(4)(i)(II) and 56(g)(4)(A)(v) are not applicable to finance lease transactions that for financial statement purposes are required to be ac-

Option 2: Provide for "deemed depreciation" based on the difference between the taxpayer's cost or carrying value and the estimated residual value of the leased asset. Such amount could then be "depreciated" using any acceptable method (e.g., straight-line) over the lease term.

Option 3: Provide for a "deemed depreciation" based upon what depreciation would have been if, for financial statement purposes, the taxpayer accounted for the lease as an operating lease.

Option 4: Indicate that in situations which, for financial statement purposes, the taxpayer accounts for finance leases pursuant to FAS 13, the Treasury should by regulation or other administrative action provide for an appropriate deemed depreciation. In no event, however, should the amount of depreciation over the term of the lease be zero.

We believe that Option 1 is the easiest to administer since no additional calculations would be required by the taxpayer. Options 2 and 3 are viable alternatives but would require additional computations. Waiting for regulations would be extremely undesirable given the backlog of current regulations projects but a solution that would permit the issuance of a ruling would be acceptable.

SUMMARY STATEMENT ON TECHNICAL CORRECTIONS ACT OF 1987

Section 701(a) of the Tax Reform Act of 1986 should be amended to clarify the computation of the depreciation adjustment that is required in determining adjusted current earnings. Presently, the language of section 56(g)(4)(A) of the Internal Revenue Code (IRC) can be interpreted several different ways, with each interpretation resulting in a different tax liability.

Several options are available for providing clarification and are listed below:

Option 1: Indicate that IRC sections 56(g)(A)(4)(i)(II) and 56(g)(4)(A)(v) are not applicable to finance lease transactions that for financial statement purposes are required to be accounted for pursuant to FAS 13.

Option 2: Provide for "deemed depreciation" based on the difference between the taxpayer's cost or carrying value and the estimated residual value of the leased asset. Such amount could then be "depreciated" using any acceptable method (e.g., straight-line) over the lease term.

Option 3: Provide for a "deemed depreciation" based upon what depreciation would have been if, for financial statement purposes, the taxpayer accounted for the lease as an operating lease.

Option 4: Indicate that in situations which, for financial statement purposes, the taxpayer accounts for finance leases pursuant to FAS 13, the Treasury should by regulation or other administrative action provide for an appropriate deemed depreciation. In no event, however, should the amount of depreciation over the term of the lease be zero.

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PROFIT SHARING COUNCIL OF AMERICA
RECOMMENDATIONS FOR S. 1350
THE TECHNICAL CORRECTIONS ACT OF 1987

The Profit Sharing Council of America recommends the following changes and clarifications be included in S. 1350, the Technical Corrections Act of 1987.

Additional Tax on Excess Distributions

1. The special grandfather rule under Sec. 4981A(c)(5) allows an employee to elect to "grandfather" the amount of his accrued benefits as of August 1, 1986. Most profit sharing plans do not value employee accounts monthly. Some value quarterly, and most value annually. It is recommended that participants be allowed to grandfather their accrued benefits as of the end of the first plan quarter ending after August 1, 1986, for those plans which value quarterly, or the end of the first plan year ending after August 1, 1986, for those plans valuing once a year. The Council also recommends that all future income attributable to the grandfathered amount be part of the grandfathered amount.

An employee who elects the special grandfather for accrued benefits as of August 1, 1986, will be denied the $150,000 limit under Sec. 4981A(c)(5)(C) or the $750,000 limit on lump sum distributions. The election of the special grandfather should not deprive the retiree from the use of the substitute $150,000 limit. This forces an employee to make an election years before a distribution is made. The Council recommends that an employee be allowed to elect the $150,000 special limit in the year of retirement. Moreover, the election of this grandfather should not be required until the year of the distribution. In 1987 or 1988, most employees will not have the information available in order to make a meaningful election.

2. The excess distribution as defined under Sec. 4981A(c)(2) would apparently require the inclusion of net unrealized appreciation in distributed employer securities as part of the excess distribution. This would include net unrealized appreciation which is excludable from a lump sum distribution under Sec. 402(e)(4)(J).

Reason dictates that the excise tax apply only to amounts includible in taxable income. This is supported by reference to the House Bill H.R. 3838, Sec. 1133, which is explained by the Report of the Committee on Ways and Means 99-426, December 7, 1985, at page 745.

That Report says, in part, at page 745:

> In applying the limit, aggregate annual distributions made with respect to a participant from all pension, profit-sharing, stock bonus, and annuity plans, ESOPs, individual retirement accounts and annuities (IRAs), and tax sheltered annuities generally are taken into account <u>to the extent includible in gross income</u>. (Emphasis added.)

The use of employer securities in profit sharing plans has long been treated favorably under the Code in recognition of the value of the employee ownership of the employer, both as an incentive to foster the welfare of the employer and to instill the pride of proprietary interest in the employees. Levying an excise tax on unrealized appreciation in distributed employer securities would be an unwarranted and unsupported diminution of that historical favorable treatment.

3. Sec. 4981A(c)(4) allows a taxpayer to use five times the amount of the limitation, or $750,000, in calculating his limitation if the taxpayer elects income averaging for a lump sum distribution under Sec. 402(e)(4)(B). A taxpayer may lose the right to elect income averaging if he has previously elected such averaging, or has made an IRA rollover of a partial distribution in the past. The Council urges that an employee should not be deprived of the special higher limit on lump sum distributions even though he is not able to elect the special averaging.

4. Sec. 4981A(c)(5) should be clarified to provide that the grandfathering applies to amounts held in IRAs, especially those IRAs which have received rollovers from qualified plans.

5. The Council recommends that Sec. 4981A(d) should be amended to allow for a deduction for the marital deduction under Sec. 2056 and the unified credit under Sec. 2010. In many cases, the amount in the qualified profit sharing plan or a rollover IRA is a major part of the estate of the deceased employee or retiree. This property is generally left to the surviving spouse. It seems unjust to impose the excess distribution penalty tax in these cases.

Extension of Special 5-year Averaging to Early Retirees

Sec. 72(t) waives the 10% early distribution penalty on lump sum profit sharing distributions before age 59½ if the employee retires under the terms of the plan after attaining age 55. However, between the ages of 55 and 59½, the employee would not be eligible for the special 5-year averaging for his lump sum distributions. The special 5-year averaging should be extended to these retirees.

Age 55 is considered early retirement age by most employers. Many thousands of employees retire at age 55, take lump sum distributions of their profit sharing accounts, and use the proceeds for retirement until age 62 when their Social Security benefits commence. Many profit sharing plans provide only lump sum distributions. It is entirely inconsistent to allow employees to retire early without penalty, but not allow them the special 5-year averaging on their lump sum distributions from their qualified profit sharing plans.

Congress recognized that early retirees should not be subject to the early distribution penalty. The intention was to allow employees the opportunity to retire at age 55 without penalty. The omission of special 5-year averaging was apparently an oversight and will act as a severe penalty on this group of retirees. The Code should be corrected to give the early retirees the intended protection.

The reduction to age 55 will have no adverse revenue effect. In fact, in the future it will enhance revenues because employees will not be encouraged to postpone their retirements and to delay receiving their lump sum distributions. Further, Sec. 1122(h)(3) of the Tax Reform Act provided a transitional rule for all employees who were age 50 on January 1, 1986. Therefore, extending the 5-year averaging to early retirees will have no revenue effect until at least 1991.

Lump Sum Distributions

Sec. 1122(h)(4) of the Tax Reform Act provides for a 5-year phase out of capital gains treatment for pre-1974 accumulations. The bill is silent as to the rate of tax applicable under the 5-year phase out. Sec. 1122(h)(3)(B) provides for a 20% tax on the capital gains portion of a lump sum distribution for an individual who attained age 50 before January 1, 1986. It is recommended that the Act be clarified to allow a 20% tax rate on the phase out of the capital gains treatment for those individuals who were not born before January 1, 1936.

There should also be a correction of the method for calculating the 5-year averaging on lump sum distributions under Sec. 402(e). Commencing in 1988, the 15% tax rate will start to be phased out under the single individual tax tables when the taxable amount exceeds $43,150. From $43,150 to $89,560 of taxable income, the marginal rate will be 33%. It is recommended that the phase out of the 15% tax rate should not be taken into account when calculating the tax under the 5-year income averaging. The phase out of the 15% tax rate will undoubtedly substantially increase the tax on many lump sum distributions and virtually eliminate any benefits such treatment might otherwise give the employee. This would certainly be contrary to the Congressional intent in providing equitable tax treatment for lump sum distributions. These distributions often represent accumulations over the employee's entire working career.

Sec. 401(m)(9) Multiple Use of the Alternative Limitation

Sec. 401(m)(9) provides that the Secretary may prescribe regulations to prevent the multiple use of the alternative limitation with respect to any highly compensated employee. The alternative limitation is apparently the 200%/2 percentage points limitation described in Sec. 401(m)(2)(A)(ii).

The non-discrimination test became effective on January 1, 1987. For many plan sponsors the calculation of this test is complex and, in the absence of regulations prescribing the details on such calculations, many employers will undoubtedly make errors. Discovery of the errors in the future can result in substantial penalties. Therefore, it is recommended that the effective date for any prohibition on the multiple use of the alternative limitation should be delayed until after final regulations are promulgated by the Secretary. The effective date should be delayed until the beginning of the first plan year following the adoption of such final regulations.

In addition, the final regulations should not restrict the use of the alternative limitation under Sec. 401(m) unless there is in fact a multiple use of the same contribution, such as a qualified nonelective contribution, under both Sec. 401(m) and under Sec. 401(k).

Loans

Sec. 72(p)(2)(C) requires "level amortization" of loans. It is unclear whether level amortization means level amortization of principal, or equal payments of principal and interest over the life of the loan. Normally, loans are repaid with equal payments. The first payments generally consist of higher amounts of interest which will decrease in subsequent payments as the principal balance decreases. It is recommended that Sec. 72(p)(2)(C) be clarified to allow level payments over the life of the loan.

Sec. 72(p)(3)(B)(ii) provides that interest is not deductible to the extent it is attributable to elective 401(k) deferrals. In many cases, a loan is secured by the non-401(k) portion of an account as well as the elective 401(k) deferral portion of the account. Thus, if any part of a loan is secured by the elective 401(k) deferral, this will taint the entire interest deduction. It is recommended that the interest deduction be denied only to the extent of the loan balance that is secured by the elective 401(k) deferral.

Sec. 72(p)(3)(B) also denies an interest deduction for a loan to a key employee as defined in Sec. 416(i). This latter section includes as a key employee any employee who satisfied the test in the plan year or any of the four preceding plan years. This definition is too broad for the purpose of denying the interest deduction. The determination of a key employee for this purpose should be based on the status of the employee as of the last day of the year preceding the first day of the plan year.

Definition of Compensation

The Technical Corrections Act of 1987 in Sec. 111(k) would make a substantive change to present law.

Sec. 414(s) presently allows the employer to elect to include any salary reductions under Secs. 125 and 401(k) as compensation for all purposes under Part I of Subchapter D of the Code.

The Technical Corrections Act would eliminate this election with respect to the definition of compensation under Sec. 415(c).

This substantive change would have little or no impact on higher-paid employees who are limited by the $30,000 maximum annual addition. However, for lower-paid employees this would reduce the compensation base upon which the 25% maximum annual addition under a defined contribution plan is determined. The ability of lower-paid employees to save for their retirement should not be sacrificed to achieve greater uniformity. As a result, it is recommended that this substantive change not be made.

ESOPs and PAYSOPs -- Diversification Requirements

Sec. 401(a)(28) requires diversification of investments in PAYSOPs and ESOPs for employees approaching retirement. Many profit sharing plans include tax credit PAYSOPs. The Tax Reform Act terminated the tax credit after December 31, 1986. Most plan sponsors will not make their 1986 contribution to the PAYSOP until 1987, when the total compensation of participants is determined. The contribution will then be invested in employer securities.

The effective date for the diversification requirements applies to stock acquired after December 31, 1986. Under most PAYSOPs, after the employer stock is purchased with the 1986 contribution, no further stock purchases will be made except for the reinvestment of dividend income on the stock then held. Requiring the diversification for the stock attributable to the 1986 contribution will impose substantial administrative burdens on most plan administrators. It is strongly recommended that the effective date of Sec. 401(a)(28) be clarified so that the contributions for 1986, which are made in 1987, and future purchases of employer stock by reinvestment of dividends should not be subject to the diversification requirements.

Respectfully submitted,

David L. Wray
President

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July 20, 1987

By Hand

William Wilkins, Esq.
Chief Tax Counsel
Committee on Finance
205 Dirksen Senate Office Building
Washington, D.C. 20515

Re: Comments on Technical Corrections Act of 1987
-- Transition Rule for Market Discount Bonds
[Tax Reform Act §1011(d); S.1350 §110]

Dear Mr. Wilkins:

I am enclosing a statement submitted on behalf of Provident Life and Accident Insurance Company and its affiliates regarding the proposed Technical Corrections Act of 1987.

The statement concerns a proposed substantive amendment contained in section 110 of the Technical Corrections Act. The proposed amendment would take away most of the transitional relief granted to Provident and other companies in section 1011(d) of the Tax Reform Act of 1986. The amendment would also abridge a grandfather rule in the 1984 Act regarding market discount bonds upon which Provident and other life insurance companies have relied.

Provident therefore urges that full, or substantially full, transitional relief be retained. This can be done within the limits of the revenue estimates made for the 1986 Act provision while at the same time making the transitional relief generic.

Provident appreciates the opportunity to comment on the proposed legislation.

Very truly yours,

Thomas A. Stout, Jr.

STATEMENT SUBMITTED ON BEHALF OF PROVIDENT LIFE AND ACCIDENT INSURANCE COMPANY ON THE TECHNICAL CORRECTIONS ACT OF 1987

Transition Rule for Market Discount Bonds

[Tax Reform Act §1011(d); H.R. 2636 §110]

Section 110 of H.R. 2636 would take away 60 percent of the transitional relief granted to 15 named life insurance companies from the repeal of the alternative corporate capital gains rate in section 1011(d) of the Tax Reform Act of 1986. This proposed amendment to eliminate most of that transitional relief is particularly unfair and certainly constitutes a substantive change in the law, contrary to the express purpose of the technical corrections bill as stated by Chairmen Rostenkowski and Bentsen. Full transition relief should be retained.

Transitional relief was granted for the market discount on certain bonds that had previously been grandfathered in the 1984 Act. This transitional relief is vitally important to these life insurance companies because grandfathered market discount bonds have been used by the companies to fund guaranteed investment contracts, which call for the payment of a fixed amount by the companies on a date certain. The companies relied on the tax treatment of grandfathered market discount bonds in establishing the guaranteed rates of interest paid under these contracts, and the companies cannot recover any increase in the tax cost of the bonds because the return on the guaranteed investment contracts is fixed. Therefore, unless full transitional relief is retained, these companies will incur significant and unrecoverable damage.

We wish to make it clear that we do not oppose an amendment to provide transitional relief for the rest of the life insurance industry. But it is unfair to make the named companies bear the cost by taking away most of their transitional relief.

The Joint Committee staff has reestimated the cost of full transitional relief and found it to be less than one-half of the amount originally projected. Indeed, we understand that, based on the revenue cost of $120 million originally estimated for the named companies, generic transitional relief can be provided to the entire life insurance industry at a rate close to the former alternative corporate capital gains rate. We also note that the proposed technical corrections provision to make generic the capital cost recovery transition rule for aircraft manufacturers in certain states [H.R. 2636 §102(d)(12)] does not similarly reduce the level of relief of manufacturers under the Tax Reform Act provision.

Therefore, we strongly urge the Committee retain substantially the tax rate of 28 percent as the transitional relief for market discount bond income covered by section 1011(d) of the Tax Reform Act for generic application of the section.

Supplemental Information

This statement is submitted by John E. Chapoton and Thomas A. Stout, Jr. of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of PROVIDENT LIFE AND ACCIDENT INSURANCE CO.

July 20, 1987

Barry M. Gillman
Managing Director

The Prudential

Prudential Capital Management International
Prudential Plaza Newark, NJ 07101
201 877-7982

July 22, 1987

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate - Committee on Finance
Room S.D.206 - Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

Technical Corrections Act of 1987

We are writing to point out a severe problem that would occur for the regulated investment companies under our management if Section 106 (n)(2) of H.R. 2636 and S. 1350, the Technical Corrections Act of 1987, is passed into law.

First, let me state that Prudential Capital Management International (a subsidiary of The Prudential Insurance Company of America) manages approximately $2 billion in SEC registered investment companies, which invest in foreign currency denominated fixed income securities which makes us one of the largest such investment managers.

The major problem in our view with Section 106 (n)(2) is that the revised definition of income taken into account for purposes of Section 851(b)(3) of the Internal Revenue Code (the so-called short-short rule) appears to apply to all types of foreign currency transactions, including settlements, interest payments and dividend payments.

We believe that it is inappropriate to include such items as the intent of the rule is to reduce short-term trading profits, not to penalize for short-term currency fluctuations unrelated to portfolio action.

It is our opinion that including such items under the "short-short" provision will be of material detriment to shareholders of these registered investment companies and thus urge you to modify Section 106(n)(2) of the Act to delete the provision relating to foreign currency gains. We view the provision as particularly troubling in that it would apply retroactively. I am including excerpts from a memorandum from attorneys Sullivan & Cromwell that expand further on this issue.

Sincerely,

Barry M. Gillman

SULLIVAN & CROMWELL

July 10, 1987

MEMORANDUM

Re: Technical Corrections Act of 1987

This memorandum discusses a provision of H.R.2636 and S.1350, the Technical Corrections Act of 1987 (the "Act"), which, if enacted into law, would significantly modify the requirement that a regulated investment company derive less than 30% of its gross income from the sale or other disposition of stock or securities held for less than 3 months. The Act was introduced in Congress on June 10, 1987 as a technical correction to the Tax Reform Act of 1986.

Section 851(b)(3) of the Internal Revenue Code of 1986 (the "Code") currently provides that a regulated investment company must derive less than 30% of its gross income from the sale or other disposition of stock or securities held less than 3 months (the so-called "short-short" rule). The stated purpose of this requirement is to prevent a regulated investment company from actively trading securities for the purpose of making short-term trading profits. *See* Rev. Rul. 75-376, 1975-2 C.B. 267.

Section 106(n)(2) of the Act amends Section 851(b)(3) of the Code to provide that income taken into account for purposes of the short-short rule includes, among other things, gross income derived from the sale or other disposition of options, futures or forward contracts held for less than 3 months and, except as may be provided in regulations, foreign currency held for less than 3 months.* If enacted in its current form, the provision would apply retroactively to taxable years beginning after October 22, 1986.

The scope of the provision is at this time unclear. While the provision applies to income from the sale or disposition of "foreign currency" held for less than 3 months, a definition of "foreign currency" is not provided. For purposes of computing a taxpayer's foreign currency gains and losses, Section 988(c) of the Code defines

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* Annex A to this memorandum sets forth the proposed amendment to Section 851(b)(3) of the Code.

"nonfunctional currency" as including coin or currency as well as any nonfunctional currency denominated demand or time deposit or similar instruments issued by a bank or other financial institution. Section 106(n)(2) of the Act would therefore appear to apply at a minimum to currency gains realized upon disposing of foreign coin or currency (for example, upon exchanging the foreign coin or currency into U.S. dollars or upon paying expenses with foreign coin or currency) and upon withdrawing funds held for less than 3 months from a foreign currency bank account for any purpose other than reinvestment in a demand or time deposit or similar instrument issued by a bank or other financial institution.

In addition, Section 106(n)(2) in its present form may also be interpreted as applying to any "foreign currency gain" as defined in Section 988(b)(1) of the Code. Such a foreign currency gain may result not only from the actual disposition of foreign currency, but also from "Section 988 transactions", which include most transactions denominated in terms of a foreign currency (e.g., purchases or sales of foreign currency denominated debt instruments or accruals of items of expense or income in foreign currency units). See generally Section 988(c)(1)(B) of the Code. If Section 106(n)(2) of the Act were interpreted as applying to such transactions, foreign currency gains realized on a settlement date attributable to exchange rate fluctuations between the trade date and the settlement date, or upon the receipt of principal on a foreign currency denominated debt instrument within 3 months of the instrument's acquisition (including principal payments on short-term debt instruments having maturities of less than 3 months) would be counted for purposes of the short-short rule. Similarly, foreign currency gains realized upon receipt of an interest payment on a foreign currency denominated bond, or upon receipt of the redemption price on an instrument bearing original issue discount in foreign currency units, might also result in short-short income to the extent attributable to interest (or foreign currency original issue discount) accrued during the 3 month period prior to the payment.

Furthermore, because Section 106(n)(2) of the Act would also apply to the sale or disposition of futures and forward contracts held for less than 3 months, that provision may also apply to any foreign currency gains realized between the date an agreement is entered into to exchange one currency for another and the settlement date (typically two banking days later). In a separate amendment made to Subpart J of the Code by the Act, all gain recognized on a foreign currency option, future or forward contract or similar financial instrument not subject to the mark-to-market rules of Section 1256 of the Code at the close of the taxable year would be treated as foreign currency gain or loss. See Section 112(t)(3)(A) of the Act.

We believe that Section 106(n)(2) of the Act inappropriately includes for purposes of the short-short rule income wholly unrelated to the purpose of that rule. That provision causes particular concern because it would be applied retroactively. Although regulations may limit the extent to which foreign currency gains will be included for purposes of the short-short rule, it must be assumed until such regulations are issued that that provision will be applied to currency gains arising in a broad range of circumstances.

Annex A

Section 106(n)(2) of the Act would amend Section 851(b)(3) of the Code to read as follows:

"(b) Limitations. -- A corporation shall not be considered a regulated investment company for any taxable year unless --

. . .

(3) less than 30 percent of its gross income is derived from the sale or disposition of any of the following which was held for less than 3 months:

(A) stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended),

(B) options, futures, or forward contracts, or

(C) except as provided in regulations, foreign currency, and".

Prudential-Bache Capital Funding

Public Finance Department

July 24, 1987

Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: S. 1350, the Technical Corrections Act of 1987

Dear Mr. Chairman:

I am writing to request your consideration of a clarification to the 1986 Tax Code which is of great consequence to the new State Revolving Fund program authorized pursuant to the "Water Quality Act of 1987", Public Law 100-4. There is a need to clarify the tax treatment of "leveraged" state obligations issued for water pollution control state revolving funds, perhaps as part of the pending technical corrections legislation.

In general, any state or local obligation that is "federally guaranteed" is not exempt from federal income tax. The tax code (I.R.C. §149) defines "federally guaranteed" broadly to include any obligation where the payment of principal or interest is guaranteed, either directly or indirectly, by the United States. Exceptions are provided in the Code for certain insurance, debt service, and housing programs. No regulations have been issued by the Treasury to provide further guidance on this matter.

The Joint Committee on Taxation, in its explanation of the 1984 Deficit Reduction Act, indicated that the Congress intended that the determination of whether a Federal guarantee exists be based on the underlying economic substance of the transaction, taking into account all the facts and circumstances. The transfer of risk to the Federal Government is a key element in determining whether a guarantee exists relating to the issue of the obligations.

Problem

Concerns have been expressed with regard to the effect of this limitation on the new State Revolving Fund ("SRF") program established by the 1987 Clean Water Act Amendments, Public Law 100-4 ("CWA"). A key element of the program is the shifting of federal water pollution control financing to the States, replacing the former federal construction grant approach with federal "seed money" (capitalization grants). Beginning in Fiscal Year 1989, as a precondition to receiving this seed money, States must establish a revolving fund as a source for loans, or to be "leveraged" and used as a revenue source or security for State issued obligations to permanently expand the fund (CWA §603(d)(4)).

Where the federal capitalization grant deposited in the State revolving fund is used as security for obligations issued by a State or to guarantee local obligations for water pollution control projects, the Internal Revenue Service might disallow the tax exemption under circumstances discussed below.

The EPA retains authority to annul a grant agreement and require all funds to be returned, with interest, including funds already expended. Annulment is authorized by regulation where a grantee: (1) makes no progress or delays a project without good cause, or (2) is found to have obtained a grant by fraud or misrepresentation, or (3) permits corrupt administrative practices, or (4) fails to meet fundamental purposes of a grant agreement.

o While few, if any, States would ever violate these rules, the Service might argue that a federal link is never broken and that these funds never become "state" funds but always retain a "federal" character. The Service might argue further that since the federal funds will be used as collateral for the obligations, risk is transferred from the State, thus the funds act as a "federal guarantee".

o On the other hand, it can be argued that, once deposited, the federal grant becomes a State fund and is not a federal guarantee. The Federal role is limited to program-level grants-making review. No direct Federal project management role occurs unless a state so requests. Each revolving fund is State designed and operated with minimal Federal requirements.

Treasury has indicated that a revenue ruling would be needed to resolve this uncertainty absent legislation. This could delay full implementation of the plan to shift water pollution control financing to the States by perhaps two-years or more. While a few states have already established revolving fund programs, the vast majority of states will begin early next year to implement such plans in view of the October 1988 deadline.

<u>Proposal</u>

The tax code should be clarified to provide that a State revenue or general obligation shall not be treated as "federally guaranteed" by reason of the fact that a federal capitalization grant for a State water pollution control revolving fund is used as a source of security for the payment of principal and interest on such obligations or is used to guarantee local obligations for water pollution control projects.

Mr. Chairman, thank you for reviewing this request. Any assistance that you can provide would be greatly appreciated by the nation's municipal waste-water treatment community. Please let me know if you or your staff have any questions about this matter.

Sincerely,

William B. James

William B. James, C.F.A.
Associate Director

Putnam

The Putnam Management Company, Inc.

One Post Office Square
Boston, MA 02109

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FEDERAL EXPRESS

July 17, 1987

U.S. Senate Committee on Finance
Room 205, Senate Office Building
Washington, D. C. 20510

Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: H.R. 2636 and S. 1350 - Technical Corrections Act of 1987 (the "Act")

Ladies and Gentlemen:

The Putnam Management Company, Inc. ("Putnam") wishes to express its views on one issue being considered in your deliberations on the Act which is of vital concern to U.S. investors who invest in foreign securities and wish to protect their investment from unfavorable changes in the exchange rate between the U.S. dollar and the applicable foreign currency.

Putnam is an investment manager for 35 U.S. mutual funds with assets of over $32 billion owned by over 1.5 million shareholders. Putnam's affiliates manage approximately $10 billion of investments for institutional clients such as pension funds. Many of these mutual fund and pension clients invest in foreign equity or debt securities when consistent with their investment objectives as a means of obtaining greater diversification and enhancing their potential capital appreciation or income, as the case may be.

It is a customary and quite prudent practice for U.S. investors to assure a U.S. dollar value to the required payment on settlement of a securities purchase, and the value of the proceeds of a sale of securities or receipt of a dividend or interest payment on securities owned, by entering into a forward contract for the applicable foreign currency on U.S. dollars, as the case may be. Furthermore, the dollar value of foreign securities positions may be protected, or hedged, by appropriate forward currency contracts. In each case, this protects the U.S. investor from the currency risk in the investment resulting from changes in the relevant exchange rates.

This particular investment practice is not speculation. It is a conservative strategy intended to reduce the risk of loss to a U.S. investor whose economic frame of reference is the U.S. dollar.

Page Two
July 17, 1987

Section 851(b)(3) of the Internal Revenue Code contains the so-called "short-short" requirement for U.S. mutual funds and requires that to be eligible for tax treatment as a regulated investment company the fund must derive less than 30% of its gross income from the sale or other disposition of stock and other securities.

We understand that Section 106(n)(2) of the Act would amend the short-short rule to include currency gains. Such a result would jeopardize the tax status of many funds investing in foreign securities for the very act of trying to protect the investment values of their U.S. shareholders. We do not believe that this is consistent with the apparent objective of Section 851(b)(3) to limit speculation and overly-aggressive trading. Indeed, to the extent that a fund was precluded from hedging against currency risk, it could be said to be assuming more speculative risk. We strongly urge your Committees to not enact any legislation that would inhibit mutual funds from seeking to reduce currency risk in foreign investing, either directly or indirectly via the short-short rule. There is no tax policy to be served by such a step, and it would be a disservice to U.S. investors.

Very truly yours,

Peter L. Curry
Senior Vice President and
Corporate Counsel

PLC/lcr

cc: Laura Wilcox, U.S. Senate Committee on Finance (5 copies)
Mary McAuliffe, U.S. Senate Committee on Finance (5 copies)
Robert J. Leonard, Esq., Committee on Ways and Means (6 copies)

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July 22, 1987

Laura Wilcox
Hearing Administrator
Senate Finance Committee
205 Dirksen Senate Office
Building
Washington, D.C. 20510

Re: Technical Issues Relating to
Section 936 Corporations

Dear Ms. Wilcox:

The following is submitted for the record on S. 1350 on behalf of the Puerto Rico, U.S.A. Foundation.

The Tax Reform Act of 1986 contains a number of amendments and provisions other than section 936, the impact of which on section 936 corporations is unclear. In addition, a transitional rule is needed to phase-in the impact of increasing from 65 percent to 75 percent the amount of gross income from an active trade or business that is required for a corporation to obtain section 936 treatment.

The following are those items that we believe should be included in S. 1350:

1. Definition of Creditable Foreign Tax.-- Section 56(f)(2)(F)(ii)(I) provides that 50 percent of any withholding tax paid to a possession of the United States with respect to dividends that are added to adjusted net book income is treated as creditable foreign tax paid by the corporation receiving the dividends. In most cases, distributions from section 936 corporations that are dividends are subject to a withholding tax, and thus, a foreign tax credit is allowed under this provision. There are some cases where the recipient of a dividend is engaged in a trade or business in Puerto Rico and the dividend is not subject to a withholding tax, but is subject to the regular corporate Puerto Rican income tax at a reduced rate. The effective rate on this dividend approximates that which would be imposed if a withholding tax had been imposed rather than the Puerto Rican corporate income tax. Technically, however, the tax that is imposed is not a withholding tax and thus, a foreign tax credit would not be allowed for these taxes. A technical amendment is necessary to make clear that all Puerto Rican income taxes on dividends may be credited for alternative minimum tax purposes.

2. Computation of Foreign Tax Credit Limitation.-- Section 59(a)(1)(C) provides for an adjustment to the foreign tax credit limitation in case the alternative minimum taxable income is increased by reason of the book income preference. It is provided that the increase in alternative minimum taxable income by reason of the book income preference is to be prorated between domestic and foreign

sources based upon the portion of the alternative minimum taxable income from domestic and foreign sources before the book income adjustment.

In the case of other preferences, alternative minimum taxable income from sources outside the United States is calculated by determining gross income from foreign sources and by allocating and apportioning a portion of expenses to that gross income. Since in many cases the nature of the items that are included in book income are not identifiable as to source, a rule of administrative convenience was adopted which provides that the ratio of foreign to domestic source is not affected by the inclusion of the book income preference. In the case of a dividend from a possessions corporation which is included in alternative minimum taxable income, foreign source income is increased by an amount that equals the amount of the dividend multiplied by the ratio of foreign to domestic source income.

If the book income is attributable to possession source dividends, then the failure to increase the ratio of foreign to domestic source income may result in a loss of credits for taxes paid to Puerto Rico. An extreme example of this would be a parent corporation that has no foreign source income other than possessions corporation dividends. In such a case, the parent would have no foreign source income before the book income adjustment and thus, the book income adjustment would be all attributable to domestic source income and there would be zero foreign tax credit limitation. While this is a problem only under the book income preference, since the earnings and profits adjustment does not contain such a proration rule, the impact could be severe to affected taxpayers. Accordingly, we recommend that the statute be amended to provide that in no event shall the increase in foreign source income be less than the amount of dividends received from all possessions corporations.

3. Interest on Puerto Rico Government Obligations.-- In the case of a section 936 corporation, the alternative minimum tax does not apply to (i) taxable income from the active conduct of a trade or business in the possession or from the sale of assets of such trade or business and (ii) gross income from sources within the possession that is from the investment in the possession of funds derived from the active trade or business or from other qualified investments (QPSII). The application of this exclusion to interest on Puerto Rico government obligations is unclear. Interest on these obligations issued prior to 1983 was exempt from U.S. income tax by virtue of section 3 of the Federal Relations Act. From 1983 to the present, the interest is excluded from gross income under section 103(a) of the Code. In either event, the interest is not in gross income and thus may not qualify as QPSII. Such a result is anomalous in that investment income which is not taxed by reason of the possessions tax credit is excluded from the alternative minimum tax, but income from Puerto Rican government sources which otherwise would be eligible for the possessions tax credit but for the fact that it is already exempt, may be subject to the alternative minimum tax. Such a result would cause taxpayers to favor "taxable" investments over Puerto Rican government investments to the detriment of the Puerto Rican government and the various programs, such as housing and Caribbean Basin Initiative in which the funds would be used. In order to eliminate uncertainty, the statute should be amended to exclude from the alternative minimum tax any amount excluded from gross income under section 103(a) which would meet the requirements of section 936(d)(2) if it were not so excluded.

4. Allocation of Expenses.-- Section 1215 of the Act amends section 864 by adding a new subsection (e) dealing with the allocation of interest and other expenses. The application of these rules to Puerto Rico is unclear. The statute says that the new section 864(e) is applicable for purposes of international provisions (except as provided in regulations).

There was a Senate floor colloquy confirmed by the Chairman of the Ways and Means Committee that provides that the provision treating all members of the affiliated group as a single corporation for purposes of allocating interest expense is not to apply for purposes of section 936(h) (relating to the profit-split and cost-sharing methods of determining income from manufacturing). The colloquy is silent as to the impact of the interest rules for other provisions as well as the treatment of other expenses.

The colloquy leaves unanswered the impact of any allocation on section 936(a). If section 864(e)(1) applies, the benefit obtained by the Senate floor colloquy would be reduced. We understand that there was no intention to allocate interest expense to the manufacturing and investment income of a section 936 company. Not applying the section 864(e)(1) rules for profit-split and cost-sharing only partly achieves this goal. Those rules determine what portion of the income from the sale of the product may be earned by the section 936 company. Section 936(a) defines what income earned by a 936 company is eligible for the section 936 credit. Thus, if the interest expense were allocated to income for section 936(a) purposes, it would reduce the amount of the credit. Accordingly, confirmation is needed that section 864(e)(1) does not apply for purposes of the section 936(a) computation.

It is also not clear, for purposes of section 904 allocations, what is the treatment of either the stock in a section 936 company or the assets of a section 936 company. For purposes of the foreign tax credit limitation, a section 936 corporation is not a member of the group and the limitation is based upon foreign source income of the group over world-wide income of the group. Neither the income nor taxes of a section 936 corporation is taken into account. Even in the case of a dividend from a section 936 corporation, the dividend has no impact on the foreign tax credit, since there is a dividends received deduction equal to the amount of the dividend. However, by taking the assets and gross income of the section 936 corporation into account as part of the group or by treating the stock of a section 936 corporation as an asset with an adjusted basis, the statute could be read as requiring the consideration of these assets and income or stock in calculating the interest and other expense allocations for purposes of section 904. It is recommended that the statute clarify the fact that for purposes of section 904 calculations, the investment in the stock or the assets and income of a section 936 corporation are not taken into account.

5. Gross Income Test.-- Section 936(a)(2)(B) was amended by the Tax Reform Act to require that 75 percent of the gross income of a possessions corporation for the three-year period immediately preceding the close of its taxable year be derived from the active conduct of a trade or business within a possession. For a calender year 1987 taxpayer, the provision appears to require that for the years 1987, 1986, and 1985 that at least 75 percent of its gross income be active trade or business income. The reduction in 1987 of the amount of allowable investment income that may be earned in prior years is a retroactive change in the law that could deny the possessions tax credit to many corporations.

Prior to amendment by the Tax Reform Act, the requirement was 65 percent for 1986 and 1985, and 60 percent for 1984. Thus, in 1986 relying on the then existing provisions, a taxpayer could have had less than 65 percent of its gross income for the three preceding years from an active trade or business income. Even if a corporation was carefully following the legislative developments regarding the Tax Reform Bill, until the Senate Finance Committee acted in July of 1986, the provision in the House Bill was the relevant consideration and the House Bill would have increased the active business requirement to only 70 percent in 1986. Accordingly, if during 1986 a corporation made immediate adjustment to compensate for the change from the 70 percent requirement of the House Bill to 75 percent of the Senate Bill, it could not, in the extreme case, have complied with the new 75 percent requirement for 1987. In order to meet the 75 percent requirement in 1987, a taxpayer who had 65 percent in 1985 and 70 percent in 1986 from an active trade or business and who had not increased its gross income in 1987 would be forced to meet a requirement of having 90 percent of its gross income in 1987 from an active trade or business.

It is recommended that the effective date of the new 75 percent requirement be phased-in in a manner so that taxpayers who have made a good faith effort to satisfy the requirement not be adversely affected. It is suggested that the testing period for the new 75 percent requirement be computed on a phase-in basis by using a weighted-average based upon the applicable percentages specified in each taxable year of the testing period. For example, if a taxpayer's gross income in 1985 was $100, in 1986, was $110 and in 1987 is $125, the test would be satisfied if $230.25 (65% of $210 + 75% of $125) was active business income. It should be kept in mind in considering this proposal that what was done for 1986 is done and therefore any change to add relief from the retroactive rules impacts only to relieve companies from the disasterous consequence of complete disqualification from section 936.

Sincerely,

Carl A. Nordberg, Jr.

Carl A. Nordberg, Jr.

FOUNDED 1873

RBMU INTERNATIONAL

CAMEROON, CHILE, IRIAN JAYA,
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July 14, 1987

Ms Laura Wilcox
US Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms Wilcox:

I have the following comments which I wish to submit for the consideration of the US Senate Committee on Finance relative to a needed amendment to the Technical Corrections Bill (S. 1350). I will be grateful for your assistance in bringing the following points before the committee.

In my opinion clarification is needed by way of an amendment to the bill so that it specifically states that charitiable gift annuities issued by IRC Sec. 501(c)(3) organizations are NOT "commercial-type insurance" under IRC Sec. 501(m).

In the case of charitable organizations, donors use gift annuities as a gifting vehicle because they desire to make a gift to the organization. A gift annuity given with this motivation does not compete with the commercial insurance industry nor is such a gift annuity "commercial-type insurance".

It is the feeling of our type of not-for-profit organization that failure to clarify the act to the effect that gift annuities to 501(c)(3) institutions will dry up an important source of funding to our organization's religious and charitable activities. Gift annuities have been used as a funding vehicle for charitable works for over 100 years. For the small donor, the charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust--this latter vehicle being unaffected by IRC 501(m).

We will appreciate your positive consideration of this matter so that the Technical Corrections Bill (S. 1350) will clarify the definition and status of charitable gift annuities as not being of the nature of "commercial-type insurance".

Thank you for your consideration.

Yours faithfully,

Dale Leathead

Dale Leathead

WRITTEN STATEMENT FILED ON BEHALF OF
RESORTS INTERNATIONAL, INC.
COMMENTING ON S.1350
(THE "TECHNICAL CORRECTIONS ACT OF 1987")

In October, 1976, Resorts International, Inc. entered into a contract with the Housing Authority of the City of Atlantic City (HACAC) pursuant to which the HACAC agreed to convey to Resorts title to a certain tract of land, in return for which Resorts agreed to construct and complete a 1,000 room resort hotel and ancillary facilities and also agreed to pay $5.6 million for the land. Under the federal income tax laws then in effect, Resorts expected to depreciate both real property improvements and personal property based on the rules then in existence and to obtain investment tax credits on the cost of the personal property.

Due to litigation involving adverse title claims against the property, HACAC was delayed in providing the clear title called for under the contract. However, plans for the hotel were submitted to the appropriate authorities and approved in 1982, and construction actually commenced in October, 1983. It is estimated that the hotel will open its doors for business in the first quarter of 1988.

The Tax Reform Act of 1986 made certain changes relating to depreciation and eliminated the investment tax credit. In an effort to grandfather projects which commenced prior to enactment of the Act, certain transitional rules were adopted, including the "equipped building" rule (see section 203(b)(1)(C) of the Act). The equipped building rule provides that where a taxpayer has incurred or committed at least 50% or more of the total cost of an equipped building prior to January 1, 1986, it will be permitted to utilize the pre-1986 depreciation ACRS guidelines and may take investment tax credits on property, including furniture, fixtures and equipment, ordered after December 31, 1985.

The application of this transitional rule turns on the meaning of the words "incurred or committed." The Conference Report indicates in an example that "incurred or committed" includes commitments under a "written binding contract." There is a difference of opinion between Senators Moynihan and Packwood (then Chairman) of the Senate Finance Committee, on the one hand, and Congressman Rostenkowski, Chairman of the House Ways and Means Committee, on the other hand, as to the meaning of a "written binding contract" in this context. The Senators in a colloquy on September 27, 1986 concluded that the term includes contracts with municipal authorities. Congressman Rostenkowski, in a response on October 2, 1986, stated that it means only a binding contract between the taxpayer and a contractor, sub-contractor or supplier, and does not include a contract with a municipal authority.

Senator Packwood in a subsequent statement of October 17, 1986 reiterated and emphasized his prior view, pointing out that the severe limitation proposed by Congressman Rostenkowski has no basis in the Statement of Managers and that the rule is not limited as Congressman Rostenkowski stated.

In view of this conflict of interpretations by the principal Congressional sponsors of the Tax Reform Act, it seems appropriate and desirable to eliminate the confusion and provide clarification in the proposed Technical Corrections Act. We believe there is merit to the position taken by Senators Moynihan and Packwood where a taxpayer, such as Resorts International, entered into firm contractual commitments in reliance on the law then in effect, long before any consideration was given to the kind of changes made in the Tax Reform Act of 1986.

In this regard, we suggest that the Technical Corrections Act provide a definition of a written binding contract to include "contracts between the taxpayer and a contractor, sub-contractor, supplier or a municipal authority (if such contract with a municipal authority was entered into prior to January 1, 1985)."

We will be glad to provide the Committee with any additional information or details which it may require, or to respond to questions.

Supplemental Sheet

Designated Representatives:

Gerald R. Cahill
Director, Finance Reporting
and Taxes
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North Miami, Florida 33161
(305)891-2500

John Antholis
Edwards & Antholis
95 Madison Avenue
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Walter J. Rockler
Arnold & Porter
1200 New Hampshire Avenue, N.W.
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(202)872-6789

Technical Correction Sought

To clarify that the "equipped building" rule (section 203(b)(1)(C) of the Tax Reform Act of 1986) is applicable in the case of a written binding contract between a taxpayer and a municipal authority entered into before 1985.

Facts as to the Resorts International Hotel Project in Atlantic City, New Jersey

Legislative History: Conflict Between Senate Colloquy and Statement of Chairman Rostenkowski

Clarification Sought

Deborah C. Rice

422 Hermosa, SE
Albuquerque, New Mexico 87108

(505) 266-3287

September 28, 1987

The Senate Finance Committee
Laura Wilcox, Hearing Clerk
SDOB 205
Washington, D.C. 20510

Dear Congressman:

I am a freelance novelist from New Mexico. I am writing to you, although I have never written to a legislator before, because my livelihood has been threatened by the application in TRA-86 of uniform capitalization rules to writers.

Uniform capitalization rules are intrinsically unworkable applied to writing due to overlapping development of projects and total unpredictability of timing or amount of income from any specific project. Asking writers to apply uniform capitalization to the constant stream of material they must produce and promote to earn a living is not unlike asking the aerospace industry to function without deducting research and development costs unless the products they invent have been manufactured and sold.

I strongly urge you and your fellow committee members to make a clarification in Technical Corrections Bill S1350, stating that freelance authors' expenses in researching and writing a book not be subject to capitalization rules.

Sincerely,

Deborah C. Rice

Deborah C. Rice

RICE UNIVERSITY
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VICE PRESIDENT FOR
EXTERNAL AFFAIRS

(713) 527-6090

June 29, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance, S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

This is a request for your assistance to keep the charitable deduction in the generation-skipping transfer tax (GS77) "inclusion ratio" formula for charitable lead trusts.

The new Technical Corrections Act would repeal this charitable deduction and, if this is done, it would be clearly substantive and not technical. Also, this proposed change is contrary to congressional policy of encouraging charitable gifts.

We hope that your leadership will ensure that the charitable deduction is kept as an offset against the generation-skipping tax on charitable lead trusts. Thank you for your consideration and assistance.

Sincerely,

Kent E. Dove

Kent E. Dove

KED:dww

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July 24, 1987

BY HAND

The Honorable Lloyd Bentsen
Chairman
Senate Committee on Finance
219 Dirksen Senate on Finance
Washington, D.C. 20510

Re: Sections 102(d)(9) and 102(e)(7) of S.1350/H.R. 2636, the Technical Corrections Act of 1987

Dear Senator Bentsen:

As you know, the Tax Reform Act of 1986 contains a series of special transition rules to permit certain taxpayers to retain the benefit of ACRS and the ITC under certain circumstances. In the case of one industry, fiber optic telecommunication systems, at least 6 separate systems received transition relief. Section 102(d)(9) of S.1350/H.R. 2636 would extend this relief to one additional such system.

Mutual Signal Corporation, another such fiber optic telecommunication system is a taxpayer that requires a similar transition rule so that it may be treated in the same fashion as its competitors.

Mutual Signal Corporation ("Mutual Signal"), a wholly-owned subsidiary of Walker Telecommunications Corp. ("Walker") is a company engaged in the business of providing fiber optic communications networks for businesses and individuals. It has placed in service a 420-mile network in Southern Michigan as of February, 1987. This network is within several hundred yards of a competing U.S. Sprint network.

In early 1985 Mutual Signal was formed to operate regional fiber optic telecommunications networks. The Michigan project was undertaken as a pilot project. It connects 13 major cities in Southern Michigan: Ann Arbor, Battle Creek, Bay City, Dearborn, Detroit, Flint, Grand Rapids, Jackson, Kalamazoo, Lansing, Midland, Pontiac and Saginaw. A total of \$32.4 million has been invested in the system.

In October of 1985 Mutual Signal obtained interim financing of \$31 million for the Michigan project. On February 24, 1986 Mutual Signal entered into a formal agreement with Bechtel Corporation for the construction of its system.

The Tax Reform Act of 1986 includes five separate special transition rules "grandfathering" various fiber optic communications networks for ACRS and ITC purposes. The projects are as follow:

U.S. Sprint	20,000-mile fiber optic network. See § 204(a)(5)(B) of the Act.
MCI	Inter-city communications link passing through at least 10 states. See § 204(a)(5)(C) of the Act.
Teleconnect	Communications network linking cities in Nebraska, Iowa and Illinois. See § 204(a)(5)(P) of the Act.
SouthernNet	Nationwide fiber optic network. See § 204(a)(32)(R) of the Act.
Kansas City Southern Industries (LDX Corp.)	$25 million fiber optic network. See § 204(a)(32)(T) of the Act.

As a result of the above transition rules, there is no "level playing field" for Mutual Signal. It is engaged in head-to-head competition with the companies owning and operating the "grandfathered" systems. Like these systems specifically identified under § 204(a)(5) of the Tax Reform Act, Mutual Signal's system was "placed in service pursuant to a master plan which is clearly identifiable as of March 1, 1986" and was under a formal agreement to commence construction as of February 24, 1986. The investment tax credit that would be permitted to be claimed would be $2.2 million.

Proposed Change

A technical correction to § 211(e)(4) of the Tax Reform Act of 1986 should be made by adding a new paragraph (C).

"(C)" A project that passes through at least 13 cities providing an inter-city communications link through a fiber-optic communications network system and before February 25, 1986, a formal agreement for the construction of the system pursuant to the master plan was entered into and at least $30 million was committed to the construction of the system shall be treated as transition property within the meaning of Section 49(e) of the Internal Revenue Code of 1986.

Should you or your staff have any questions regarding this proposed change, please feel free to call me at any time at 331-7760. Thank you for seriously reviewing this proposed change.

Sincerely yours,

Bill

William Morris

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July 24, 1987

BY HAND

The Honorable Lloyd Bentsen
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: §203(b) of S. 1350/H.R. 2636, The Technical Corrections Act of 1987

Dear Senator Bentsen:

Section 203(b) of S. 1350/H.R. 2636, referred to above, amends Section 8011 of the Omnibus Budget Reconciliation Act of 1986. We are writing to urge a further modification of §8011.

In 1986 Section 8011, referred to above, amended Section 5061(d)(2) of the Internal Revenue Code to require that a Foreign Trade Zone be treated as if it were a customs bonded warehouse where bottled imported distilled spirits, wine and beer are brought into a zone.

Prior to enactment of P.L. 99-509, importers were permitted to temporarily house imported bottled distilled spirits, wine and beer in foreign trade zones and then to transfer such goods to customs bonded warehouses without treating such transfers as entries into the Customs Territory of the United States. The new law requires the payment of excise tax on removal of product from the first customs bonded warehouse or foreign trade zone.

This change of law has inadvertently encouraged importers to consider by-passing U.S. foreign trade zones where their product formerly was manipulated (i.e., inspected, tested, labeled, stamped, re-packed, etc.) and to accomplish these operations outside the United States. The result has been a loss of business and jobs in U.S. zones. In New York FTZ #1, 50 employees have been laid-off to date and unless the new law is changed, approximately 100 additional employees will be terminated by the end of the year.

The unintended result of this new law is peculiar to foreign trade zones because of the distribution network used for such articles, and because zones customarily do more than store distilled spirits, wine and beer. Section 3 of the Foreign Trade Zones Act authorizes these articles to be re-packed, assembled, distributed, sorted, graded, cleaned, broken-up, mixed with foreign or domestic merchandise, labeled, re-labeled, exhibited, or otherwise manipulated and be exported, destroyed, or sent into Customs territory of the United States.

Because of this authorization, foreign trade zones are distinctly different from customs bonded warehouses. Zones are more difficult to establish, they permit a wider range of operations and they create jobs. CBWs, on the other hand, are used for passive storage and warehouse operations and are the final distribution point for products entering the U.S. market.

CBWs have not been affected by this change. Importers continue to make use of customs bonded warehouses, only now their product is more often transferred to a CBW from a foreign country, where manipulation occurs, rather than from a U.S. foreign trade zone.

Customs Bonded Warehouses cannot convert to a foreign trade zone. Foreign Trade Zone applicants must comply with a very detailed and prolonged application process (currently up to two years) and must have authority from their respective State legislature. Zones must be operated as public entities and be located at or near a U.S. Customs port of entry. Zone applicants must also have the consensus approval of the local community including the local elected officials, local governments, and economic development authorities. Finally, foreign trade zones must pay an annual U.S. Customs fee, much higher than that assessed a bonded warehouse, and must also satisfy strict Customs' security requirements.

Because of the manner in which imported spirits are distributed in the U.S., importers do not transfer their product from one customs bonded warehouse to another. Thus, the Customs Bonded Warehouse Association is not seeking the ability to ship "in-bond" from one CBW to another, but is supportive of the ability to transfer product from an FTZ to a single CBW.

On behalf of the National Association of Beverage Importers, we are writing to urge the members of the Committee on Finance to restore prior law, permitting tax-free transfers of imported bottled distilled spirits, wine and beer from FTZs to CBWs. For the Committee's information enclosed is a brief memorandum explaining that the interest of the U.S. Government is more secure under a system that facilitates movement of such goods to CBWs where there must be a bond to protect the government's interest in the payment of any tariffs or duties. Also enclosed is the legislative history of the Foreign Trade Zone Act setting forth the purposes for which such facilities have been established. We hope this information is helpful in analyzing the merits of this proposed change.

Should you or your staff have any questions regarding this proposed change, please feel free to call me at 331-7760.

Sincerely yours,

William Morris

Enclosures

BY

PAUL SACK

Principal, The RREEF Funds
650 California Street
San Francisco, California 94108

COMMENTS ON SECTION 116 OF S. 1350
DEALING WITH
SECTION 501(c)(25) CORPORATIONS

I. Background

The RREEF Funds are the largest group of closed-end, tax-exempt real estate investment funds in the United States. Since 1975, The RREEF Funds have provided an opportunity for pension plans and governmental plans to invest in a series of professionally managed, commingled, closed-end real estate investment funds. At this time, The RREEF Funds have over $3.0 billion subscribed or under management for exempt organizations.

Since the 1970s, The RREEF Funds have acted as the real estate adviser to pension and governmental plans that have pooled their investments through the use of a group trust. See Rev. Rul. 81-100, 1981-1 C.B. 326. A group trust is a pension trust described in section 401(a) that can have as beneficiaries only other pension trusts governmental plans and individual retirement accounts. See section 401(a)(24). The IRS National Office has extended tax-exempt status to a section 501(c)(2) corporation wholly-owned by a group trust. See G.C.M. 38253 (Jan. 23, 1980).

The group trusts organized and managed by The RREEF Funds have invested in institutional quality real estate such as shopping centers, office complexes and industrial parks. The group trusts hold title to and manage these properties so as to generate little, if any, unrelated business income. Thus, the group trusts' principal source of income is rentals from real property and incidental personal property. The group trusts managed by The RREEF Funds have never been formed to invest in personal property unrelated to real estate such as stocks and bonds or computers.

There are three primary shortcomings to the group trust as an investment vehicle for tax-exempt entities. The first is the limitation on eligible investors in the group trust. Tax-exempt foundations, religious institutions, endowments, museums, hospitals and other organizations exempt under section 501(c)(3) cannot invest in group trusts. Throughout the years, The RREEF Funds had been compelled to turn down requests to manage real estate for universities and private foundations because such organizations could not participate in a group trust.

Second, under local law each pension plan may be considered the direct co-owner of the real property owned by the group trust. This means that each pension plan may be liable for any injury or accident occurring on the property for an unlimited amount. Given the state of the insurance industry, it is often prohibitive or impractical to obtain as much insurance as much as one might like for these risks, and therefore under the present arrangement a pension plan could sustain a loss even exceeding its total investment in a group trust. Pension plans and investors of all sorts often prefer to use a corporate entity as the vehicle for their investment because under state law the corporation provides limited liability, i.e., each plan would be liable only to the extent of its corporate investment.

The third problem concerning group trusts centers on transactions involving the unrelated business income tax ("UBIT"). This separate tax does not apply to certain income items such as dividends, interest and certain real property rents unless the exempt organization incurs debt to acquire or improve the property generating such income items. If it holds such "debt-financed property," the exempt entity is taxed on a portion of the income generated by the leveraged property pursuant to section 514.

In 1980, Congress added section 514(c)(9) permitting any trust described in section 401(a) such as a group trust to acquire real property subject to leverage without owing any unrelated business income tax so long as several stringent conditions are met. Such conditions serve to prevent the benefits of this exception to the acquisition indebtedness rules from being passed on to the seller of the property acquired by the qualified trust. For example, the exception only applies if the acquired property is not leased back to the seller and the property is not acquired from a party related to the qualified trust or any participant in the qualified trust. Congress extended this exception to the acquisition indebtedness rules to certain educational institutions in 1984.

Section 514(c)(9) solved the problem faced by a group trust when it acquired property subject to existing debt at favorable rates or debt that could not be paid off without a significant prepayment penalty. However, the benefits of this section do not apply to a group trust's section 501(c)(2) subsidiary. See, e.g., Private Letter Ruling 8326173. Thus, prior to the 1986 Act it was impossible to achieve simultaneously the protection of limited liability and the treatment granted by section 514(c)(9). Also, section 501(c)(3) charities could not participate in a group trust.

II. Legislative History

A. 98th Congress

To address these inequities, Senator Packwood and Congressmen Matsui and Archer introduced legislation in the 98th Congress that would have allowed up to 35 pension plans, governmental retirement plans, governmental units and charities described in section 501(c)(3) to invest in an exempt corporation that would qualify for the exception to the debt-financed property rules applicable to pension plans.

The Subcommittee on Taxation and Debt Management of the Senate Finance Committee held a hearing on Senator Packwood's bill (S. 1815) on September 26, 1983. Testifying on behalf of the The RREEF Funds, a Morrison & Foerster partner explained why the Treasury Department at that point opposed S. 1815:

> As I understood, the Treasury testimony basically made two points:
>
> First, with respect to the unrelated income tax point, they say that they never liked it in the first place, Congress should never have extended [the exception to the acquisition indebtedness rules to] pensions, and since they didn't like it in the first place it shouldn't go any further; although they admit in their testimony that the distinction between pensions and other tax-exempt institutions, section 501(c)(3), educational institutions and foundations, is as they say "tenuous."
>
> Senator Packwood. Yes. They would be very happy if we repealed the pension exemption.
>
> Mr. Silberman. My view as a matter of public policy and my clients's view as a matter of public policy, as the institution which operates and provides an investment vehicle for these institutions, is that there is no distinction between the two-- the 501(c)3's on the one hand and the pensions on the other, and I think Treasury recognizes it.
>
> So the Congress really has two choices: One, do you repeal the provision for the pensions, which Congress is never going to do? Or, two, do you rationalize it by giving the same benefits to the educational institutions and foundations?
>
> And in a time of budget-cutting on the part of the Government, it seems almost absurd to suggest that the Government does not have an interest in increasing the corpus of educational institutions and foundations which perform much of the work that the Government otherwise would do if it had more funds. So that's No. 1 with respect to the Treasury's objection to extending the unrelated business income tax beyond pensions to educational institutions and foundations and the corporations which [S.] 1815 would set up to do that.
>
> . . .
>
> Senator Packwood. I think your point is well taken, and, Mr. Silberman,

> you are right, we are not going to repeal the exemption for pensions. You can picture the yell that would go up if we start down that road. So we start with premise-A -- that is not going to change.
>
> Clearly I think it is unfair competition, one. Two, the purposes that this bill is directed to are clearly in the public interest; Treasury doesn't even argue that in terms of who we are trying to benefit.

1983-84 Miscellaneous Tax Bills--VII, Hearing Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, 98th Cong., 1st Sess. 158-59 (September 26, 1983).

Clearly, this quotation shows that Senator Packwood thought that it was unfair that pension plans could incur debt to acquire real property without being taxed, while section 501(c)(3) charities could not. His legislation (which was dropped from DEFRA in conference but, on the section 514(c)(9) issue, incorporated intact by last year's Finance Committee bill) remedied this by allowing a collective investment corporation to qualify for the acquisition indebtedness exception on the entity level so that its charitable shareholders could indirectly benefit to the same extent as its pension plan shareholders.

B. 99th Congress

After consulting with the Treasury Department to address its concerns with the legislation that was not adopted as part of DEFRA, Congressmen Matsui and Archer co-sponsored H.R. 3301 in the 99th Congress. Like its predecessor in the 98th Congress, H.R. 3301 expressly amended Code section 514(c)(9) to extend the exception applicable to pension plans to the new collective investment corporation at the entity level. As stated in Congressman Matsui's introductory remarks:

> [T]his bill provides that section 501(c)(24) organizations will be eligible for the acquisition indebtedness rules enacted in 1980 for pension plans, thus removing another inconsistency with respect to investment by tax-exempt organizations.

131 Cong. Rec. E 4025 (Daily ed. Sept. 12, 1985).

Senator Wallop introduced the companion bill, S. 1808, with an identical intent. Senator Wallop stated:

> As a result of the recent piecemeal changes in tax laws regarding real estate investment by tax-exempt groups, opportunities currently available only to the largest of them are not within reach of the smaller ones. Pension trusts, government plans and educational institutions are allowed, because of amendments to the code made in 1980 and

> 1984, to invest in leveraged real estate without being held liable for taxes on the income produced thereby, but the smaller organizations <u>such as private foundations and charities are not able to take advantage of this.</u>
>
> * * *
>
> The legislation I introduce today would correct inequities and expand the opportunities to these organizations to invest in real property by creating a new corporate investment entity free of current restrictions. . . . [Emphasis added].

131 Cong. Rec. S 14458 (Daily ed. Oct. 30, 1985). Clearly, Senator Wallop introduced this legislation to allow all Section 501(c)(3) charities to take advantage of the Section 514(c)(9) exception by investing in a Section 501(c)(25) corporation.

Obviously, the inconsistency in the UBIT rules would not have been resolved if the UBIT exception were applied on the shareholder level because some shareholders would be subject to tax while others would not. This is why H.R. 3301 and S. 1808 used an entity level test.

The following year, Congressman Matsui asked Chairman Rostenkowski to refer H.R. 3301 to the Subcommittee on Select Revenue Measures for a hearing so that it could be considered as part of the tax reform bill. Again, Congressman Matsui's intent on the UBIT issue was precise. In a letter to the Chairman dated February 18, 1986, Congressman Matsui stated:

> Amendments in 1980, 1982 and 1984 permitted pension trusts, governmental plans and educational institutions to invest in leveraged real estate without incurring taxable income as a result; this opportunity remains foreclosed to other tax-exempt organizations such as private foundations and charities.
>
> H.R. 3301 will provide a new investment vehicle that will treat tax-exempt entities equally with respect to debt-financed real estate transactions.

Again, the method by which H.R. 3301 achieved this goal was to extend the exception to the acquisition indebtedness rules to a section 501(c)(25) corporation at the entity level so that <u>all</u> qualified exempt shareholders would not be subject to UBIT if the corporation invested in leveraged real estate.

At the hearing before the Select Revenue Measures Subcommittee held on May 19, 1986, all witnesses who testified on this issue expressed their clear understanding that charitable shareholders of a section 501(c)(25) corporation would not be subject to UBIT if the corporation used debt to acquire or improve real estate. Indeed, some organizations premised their support of H.R. 3301 upon this very idea.

The Treasury Department, which had opposed the predecessor legislation introduced in the 98th Congress, acquiesced to H.R. 3301 and expressed its understanding of the section 514(c)(9) change as follows:

> H.R. 3301 also would extend to collective real estate investment corporations the provision of current law that generally exempts certain real estate investments of qualified pension trusts and educational institutions from the debt-financed property rules. By extending the exception to such corporations, the bill indirectly would extend the exception to _all_ organizations eligible to own beneficial interests in such corporations.
>
> On several prior occasions, the Treasury Department has testified that the debt-financed property rules should not be narrowed. . . .
>
> Several developments subsequent to our prior testimony have caused us to alter our position regarding expansion of the exception to the debt-financed property rules. . . . Our acquiescence in this narrowing of the debt-financed property rules is based on our judgment that, in their present form, the rules make an untenable distinction between educational organizations and other section 501(c)(3) organizations [emphasis added].

Miscellaneous Tax Bills, Hearings Before the Subcommittee of Select Revenue Measures of the House Ways and Means Committee, 99th Cong., 2d Sess. 190 (May 19, 1986). In addition, the Treasury Department suggested that section 514(c)(9) be further amended to extend the UBIT exception to direct real estate investments by a charity. _Id_.

The organizations that commented on H.R. 3301 reiterated Treasury's understanding of H.R. 3301. The RREEF Funds testified that:

> The bill would also extend to these section 501(c)(25) corporations the exemption from the unrelated business income tax on debt-financed property currently extended to pension trusts, governmental plans, and certain educational institutions, thereby correcting the unfair treatment of investments by other exempt organizations such as foundations, religious institutions, museums, and nonprofit hospitals which currently do not qualify for this exemption.
>
> . . .
>
> The collective investment entity under H.R. 3301 would allow tax-exempt organizations to

> pool their resources without the restrictions imposed under current law, including the acquisition indebtedness rules that now apply to charities but not to pension plans, governmental plans or educational institutions.

Id. at 274-75.

Other organizations submitted statements in support of H.R. 3301 that expressed a similar understanding of the intent underlying the Code section 514(c)(9) change. For example, the Pension Real Estate Association stated:

> The bill also would exempt these [section 501(c)(25)] organizations from the unrelated business tax on debt-financed income pursuant to rules that currently apply only to qualified plans and certain educational organizations. PREA supports the removal of this inconsistency in current law which treats various types of tax-exempt organizations differently.

Id. at 374.

Several charitable foundations also sent letters to the Subcommittee in support of this provision. For example, the Richard King Mellon Foundation wrote:

> The proposed Bills would permit foundations to indirectly become equity owners of leveraged real estate without incurring the unrelated business income tax. As you are aware, the Internal Revenue Service has already accorded pension funds and educational institutions this status. We view this as a very significant factor from an investment standpoint because the use of debt (particularly when an investor can assume existing debt at lower rates) can enhance investment returns. We strongly recommend that this portion of the legislation not be deleted during any hearings.

In addition, a report was prepared by a recognized economics analysis firm that calculated the revenue impact of H.R. 3301 on the assumption that the only revenue loss would occur because the Code section 514(c)(9) exception applicable to pension plans would apply to non-university charities for the first time. Id. at 368-73. The revenue estimators at the Joint Committee on Taxation and the Treasury Department told the economics analysis firm that the only revenue loss generated by H.R. 3301 and S. 1808 resulted from the fact that, for the first time, private foundations and other non-university charities would qualify for the exception to the debt-financed property rules.

Finally, Congressman Matsui's statement submitted for the record repeated his earlier-stated intent to remove the inconsistent UBIT treatment of tax-exempt organizations. Id. at 366-67.

S. 1808 was adopted by the Senate and accepted by the House conferees as section 1603 of the Tax Reform Act of 1986. The above legislative history leaves no doubt that Congress intended to extend the section 514 exception to a section 501(c)(25) corporation at the entity level so that all of its qualified shareholders would not be subject to UBIT if it invests in leveraged real estate.

III. S. 1350

A. Debt-Financed Rules

Section 116(a)(5) of S. 1350 (the Technical Corrections Act of 1987) would reimpose the inconsistent treatment under prior law. Under this proposed change, any non-university charitable shareholder of a section 501(c)(25) corporation would be subject to UBIT if the corporation invests in leveraged real estate. This proposed change would contradict the clear legislative intent summarized above and would go well beyond the scope of a technical correction.

If the proposed statutory amendment were to go into effect, a non-university charity likely would not invest in real estate with pension plans, governmental plans or universities through a section 501(c)(25) corporation because a leveraged investment would result in a tax on the charity but not on the other shareholders. Any such result would frustrate the clearly expressed Congressional intent of permitting all section 501(c)(3) charities to pool their real estate investments with other types of exempt organizations on an equal basis.

This proposed rule would create an intolerable conflict of interest among shareholders of a section 501(c)(25) corporation that would lead investment advisers like The RREEF Funds to exclude private foundations and other charitable institutions from the section 501(c)(25) corporations they sponsor. Otherwise, when the investment adviser uses leverage to maximize the fund's return pursuant to its fiduciary responsibility mandated by ERISA, the charitable shareholders would be subjected to UBIT.

One wonders why Congress would permit charitable organizations to be shareholders of a section 501(c)(25) corporation if they would be singled out as the only type of shareholder of a section 501(c)(25) corporation that does not qualify for the UBIT exception. The above legislative history evidences the opposite Congressional intent which S. 1350 would reverse without cause.

Last, this proposed change to section 501(c)(25) would again raise artificial distinctions between universities on the one hand and other charities on the other. As Senator Packwood stated in the 98th Congress and as Congressman Matsui and Senator Wallop stated in the 99th Congress, there is no justifiable policy reason why universities should receive the same debt-financed property exception as pension plans while foundations, museums, nonprofit hospitals, religious institutions and other charities do not.

Enactment of section 116(a)(5) of S. 1350 is contrary to clear Congressional policy adopted in 1986 and would be a significant step backward. We urge the Committee to let section 514(c)(9) stand as currently written.

B. Joint Ventures

Section 501(c)(25) corporations must own only "real property." Section 116(a)(1) of S. 1350 would exclude from the definition of real property "any interest as a tenant in common (or similar interest) and shall not include any indirect interest." The Joint Committee pamphlet accompanying S. 1350 states:

> This rule ensures a consistent application of the intent of section 501(c)(25) that a title-holding company is required to hold real property directly and cannot, for example, treat an interest in a partnership, trust, or other entity as an investment in real property.

Description of the Technical Corrections Act of 1987, JCS-15-87 at 280 (June 15, 1987).

Nothing in the legislative record suggests that section 501(c)(25) corporations should be prevented from owning indirect interests in real property. In fact, just the opposite.

The Senate Finance Committee Report states that it adopted this new provision because:

> smaller, unrelated tax-exempt organizations should be able to pool investment funds for purposes of investing in real estate through a title-holding company, with the same tax treatment as is available under present law to a larger tax-exempt organization having as a title-holding subsidiary that is tax-exempt as an organization described in section 501(c)(2).

S. Rep. No. 313, 99th Cong., 2d Sess. 885 (1986).

Without a doubt, this quotation shows that section 501(c)(25) corporations were intended to be have as least as much flexibility in making its investments as a section 501(c)(2) corporation owned by a large exempt organization such as a group trust. Otherwise, the two types of title-holding companies would not receive the same "tax treatment."

The IRS acknowledges that a section 501(c)(2) corporation may hold a partnership interest. See, e.g., G.C.M. 39597 (Jan. 22, 1987). Specifically, the IRS routinely issues determination letters to section 501(c)(2) corporations owned by group trusts when the articles of incorporation expressly empower the corporation to acquire co-ownership interests. For no compelling reason, S. 1350 would impose a different "tax treatment" on a section 501(c)(25) corporation that invests in a partnership.

Section 1603(b) of the 1986 Act added section 501(c)(25) corporations to the list of "qualified organizations" under section 514(c)(9). Because this exception to the acquisition indebtedness rules only applies to acquisitions of "real property," section 514(c)(9) serves as the best evidence of how Congress intended such term should be construed for purposes of section 501(c)(25).

Under section 514(c)(9)(b)(vi), a qualified organization may obtain the benefit of section 514(c)(9) if it enters into a partnership that acquires real property. For these purposes, a qualified organization is considered as acquiring real property that is actually acquired by the partnership. This "look-through" rule is consistent with the general principles underlying Subchapter K as well as with the treatment of partnerships owning real property as real property for purposes of the REIT rules. See Treas. Reg. § 1.856-3(g).

Section 116(a)(1) of S. 1350 also would impede the goal of a section 501(c)(25) corporation from achieving the maximum amount of geographic and functional diversity. Put simply, premium real estate of the type acquired by exempt commingled funds are very expensive. Acquiring co-ownership interests provides an excellent method of diversifying the number of properties a fund owns, the geographical locale of such properties and the types of such properties.

Without the ability of entering into co-ownership arrangements, a section 501(c)(25) corporation might be faced with the choice of either incurring unwanted debt to finance additional acquisitions or owning a smaller number of properties that may not satisfy the ERISA-imposed fiduciary requirements. Further, some types of premium real estate properties may not be acquired by fee simple. For example, developers of regional shopping malls virtually always retain a minority interest in regional shopping malls.

There is no apparent policy reason for forbidding a section 501(c)(25) corporation from making these real estate opportunities. If the concern is that the 35-shareholder limit may be avoided by using partnerships, a simple attribution rule adopted by regulations will suffice. Cf. Prop. Treas. Reg. § 1.1361-1A(e)(1) (stock held by tenants in common or joint tenants is considered to be owned by each co-owner for purposes of the 35-shareholder rules for S corporations).

The proposed statutory amendment in section 116(a)(1) would restrict the operation of section 501(c)(25) corporations unnecessarily and should not be adopted.

C. Subsidiaries

Under current law, one section 501(c)(25) corporation can be a shareholder in another section 501(c)(25) corporation. See section 501(c)(25)(C)(v). This provision was added by the conferees after The RREEF Funds pointed out that group trusts typically create a new section 501(c)(2) company for each property it acquires. This way, any unforeseen liability arising on one property will not affect the group trust's investment in the other properties because of the corporate characteristic of limited liability under state law. Cf. Rev. Rul. 76-335, 1976-2 C.B. 141.

Section 116(a)(3) of S. 1350 would delete section 501(c)(25)(c)(v) and instead would treat a section 501(c)(25) corporation as directly owning the assets of its wholly-owned subsidiaries. The Joint Committee pamphlet explains that this change would be made "to implement the 35-person limitation on shareholders or beneficiaries of a section 501(c)(25) organization. . . ." See JCS-15-87, supra at 280.

As stated above, no statutory amendment is needed to enforce the 35-shareholder limitation because the Treasury Department has sufficient regulatory authority to impose attribution rules. Further, the proposed amendment would cause serious problems.

The structure paralleling the group trust/title-holding companies structure would be imperilled by the proposed change because the wholly-owned subsidiaries of a section 501(c)(25) corporation would not be exempt for federal tax purposes and therefore likely will be treated as taxable corporations for state tax purposes. Several states such as New York and Texas have recently passed legislation specifically exempting section 501(c)(25) corporations and many other states such as Illinois automatically exempt organizations that receive an IRS determination letter. However, such local actions would be negated by section 116(a)(3) of S. 1350 because no section 501(c)(25) corporation would be willing to establish subsidiaries if they are subject to state or local taxation.

In addition, the proposed change would prevent a section 501(c)(25) corporation from acting as the vehicle for a joint venture for qualifying exempt organizations. The group trusts such as those for which The RREEF Funds serve as investment adviser often enter into a partnership with a governmental retirement plan to jointly invest in a specific property. A section 501(c)(25) corporation would be the ideal vehicle for this joint venture because of its limited liability. However, S. 1350 would prevent a commingled section 501(c)(25) corporation from doing this because it could not acquire an interest in another section 501(c)(25) corporation. There is no reason for this prohibition so long as the number of shareholders in the commingled section 501(c)(25) corporation plus the governmental plan is not greater than 35.

Section 116(a)(3) of S. 1350 is another example of a substantive provision that has no place in technical

Our common stake in the future

Department of Planned Giving
and Special Gifts
Rutgers University Foundation
192 College Avenue
New Brunswick, New Jersey 08903
201/932 8808

June 30, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Attention Senate Finance Committee:

I am writing to protest the repeal of the charitable deduction as an offset against the generation-skipping tax on charitable lead trusts.

The repeal of this important deduction would clearly be a substantive change in the new tax law. It was my understanding that the Technical Corrections Act was not supposed to make substantive changes of any kind.

It would also be bad policy, as it would unnecessarily discourage a potentially important source of support for Rutgers University, and other nonprofit institutions.

Please do not allow this deduction to be eliminated.

Thank you.

Sincerely,

David G. Clough
Director of Planned Giving
The Rutgers University Foundation

SAFECO INSURANCE COMPANIES
SAFECO PLAZA
SEATTLE, WASHINGTON 98185

TELEPHONE (206) 545-5000

Dear Ms. Wilcox:

This letter is in response to the Senate Finance Committee's request for private-sector comment on S1350/HR2630.

Prior law allows a so-called "excess" defined benefit plan to integrate with Social Security benefits to the extent that the maximum percentage spread between the benefit percentage based on compensation below the integration level (base benefit) and that based on compensation above the integration level (excess benefit) may not exceed 37½%. So for example, a defined benefit plan that provides an excess benefit of 45% of compensation must also provide a base benefit of 7.5% of compensation. Another way of stating this formula is 7.5% of all compensation plus 37½% of excess compensation.

Under Section 1111 (a) of TRA '86, the maximum excess spread percentage is changed. Now, this percentage may not exceed .75% multiplied by the participant's years of service, to a maximum spread of 26.25% (.75% x 35 years).

The problem the Technical Corrections Bill failed to correct is contained in the last sentence of Section 1111 (a) (4) (A): "In no event shall the maximum excess allowance exceed the base benefit percentage." Suppose a participant has 25 years of service at retirement age. His/her maximum excess spread is 18.75% (.75% x 25 years). According to the sentence just quoted, the base benefit percentage must also be 18.75%. But that would require a benefit formula equivalent to 18.75% of <u>all</u> compensation and 0% of <u>excess</u> compensation. In other words, the benefit formula could never be integrated under the law as it is now written.

The Conference Committee Report, Page II-433, states that "A defined benefit pension plan meets the disparity limits for integrated excess plans if (1) the excess benefit percentage does not exceed 200 percent of the base benefit percentage ...". Using my example, if the excess benefit percentage is 18.75%, the base benefit percentage must be 9.375%, not 18.75% as the law now requires.

In accordance with the Conference Committee Report's interpretation, I would propose changing the sentence to "In no event shall the maximum excess allowance exceed the benefit percentage of all compensation". Under this formulation, the committee's 200% rule is met. My example would now be 18.75% of excess compensation plus 18.75% of <u>all</u> compensation (equivalent to 18.75% of base compensation plus 37½% of excess compensation).

Thank you for your consideration of this matter.

Sincerely,

Steph Tredway

Stephen Tredway
Pension Analyst
Pension Department
dw 5.14

LAW OFFICES

SANDERS, SCHNABEL & BRANDENBURG, P. C.

*ALSO MEMBER OF MARYLAND STATE BAR
†ALSO MEMBER OF VIRGINIA STATE BAR
‡NOT ADMITTED IN D C

July 14, 1987

Ms. Lora Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
U.S. Senate
Washington, D.C. 20510

Dear Ms. Wilcox:

This is in response to the request for comments on S. 1350, The Technical Corrections Act of 1987. These comments are submitted on behalf of James J. Albertine, Director of Government Affairs, American Society of Association Executives ("ASAE"). A brief biographical statement concerning ASAE is enclosed for your information. ASAE seeks to modify the definitions of highly compensated employee and key employee in the Internal Revenue Code ("Code") to include a cost of living adjustment to the current dollar amount in the officer portion of the definitions based on the adjustment under Section 415(d) of the Code.

A one page summary of these comments is enclosed. Also enclosed are four additional copies of the comments and the summary.

Background

The Tax Reform Act of 1986 included a definition of "highly compensated employee" in Section 414(q) of the Code to be used for numerous tax-qualified pension plan purposes. The officer component is the primary component of the highly compensated employee definition that applies to the members represented by ASAE. A highly compensated employee is defined as an employee who, at any time during the current year or the preceding year (a) was a 5% owner, (b) received more than $75,000 in annual compensation, (c) received more than $50,000 in annual compensation and was a member of the top 20% of employees ranked by compensation (the "top-paid group"), and (d) was an officer and received more than $45,000 (150% times the maximum dollar limit on Annual Additions for defined contribution plans).

Section 111(j)(1) of S. 1350 would amend the definition of "highly compensated employee" in Section 414(q) of the Code to adjust the $75,000 and $50,000 amounts for cost of living adjustments made under Section 415(d) to the dollar limit applicable to defined benefit plans. Section 111(j)(1), as written, does not contain a similar cost of living adjustment to the $45,000 amount.

Section 416 of the Code contains a definition of "key employee" for purposes of the top-heavy rules. That definition includes an officer earning more than $45,000 (150% of the dollar limitation on Annual Additions for a defined contribution plan). Thus, the officer component of the key employee definition is identical to the officer component of the highly compensated employee definition. S. 1350 does not contain any provision relating to the definition of "key employee".

ASAE's Position

ASAE believes that the dollar amount in the officer component of the highly compensated employee definition should be subject to cost of living adjustments at the same time and in the same manner as the adjustments to the $75,000 and $50,000 dollar amounts in that definition. The Description of the Technical Corrections Act of 1987 prepared by the staff of the Joint Committee on Taxation, dated June 15, 1987, states at page 112 that the reason for the adjustment to the $75,000 and $50,000 amounts is "to prevent the definition of 'highly compensated employee' from becoming inappropriate by virtue of inflation." In ASAE's view, the same logic applies to the dollar amount in the officer component of the highly compensated employee definition.

The dollar amount in the officer component of the highly compensated employee definition is equal to 150% of the dollar limit on Annual Additions to a defined contribution plan under Section 415(c)(1)(A). The dollar limit under Section 415(c)(1)(A) is $30,000 or, if greater, 1/4 of the dollar limitation applicable to defined benefit plans under Section 415(b)(1)(A). The defined benefit plan dollar limitation under Section 415(b)(1)(A) is currently $90,000. This limit is scheduled to be adjusted under Section 415(d) of the Code in 1988. The dollar limit on Annual Additions will not be adjusted until the defined benefit plan dollar limitation exceeds $120,000. Based on the recent rate of inflation, it is unlikely that the defined benefit plan dollar limitation will increase from $90,000 to more than $120,000 in the next several years.

The adjustments to the $75,000 and $50,000 amounts in the definition of highly compensated employee are based on the adjustments to the defined plan dollar limitation. Therefore, the $75,000 and $50,000 amounts will be adjusted for inflation as early as 1988. The dollar amount in the officer component of the definition of highly compensated employee is based on the adjustment to the defined contribution plan dollar limitation. Because the defined contribution plan dollar limitation is unlikely to increase for a number of years, the dollar amount in the officer component of the definition of highly compensated employee is unlikely to increase for a number of years.

ASAE believes that the same sound policy reasons that dictate an adjustment to the $75,000 and $50,000 amounts "to prevent the definition of 'highly compensated employee' from becoming inappropriate by virtue of inflation" also apply to the dollar amount in the officer component of the definition of highly compensated employee. Further, the adjustment to the dollar amount in the officer component should be made at the same time and in the same manner as the adjustment to the $75,000 and $50,000 amount. This can be accomplished in S. 1350 by changing the officer component of the highly compensated employee definition in Section 414(q)(1)(D) of the Code to reference the current $45,000 amount in effect, and by modifying Section 111(j) of S. 1350 to amend Section 414(q)(1) of the Code to authorize the Secretary of Treasury to adjust the $75,000, $50,000 and $45,000 amounts at the same time and in the same manner as under Section 415(d) of the Code.

The officer component of the highly compensated employee definition appears to be based on the officer component of the key employee definition. The key employee definition does not include any specific cost of living adjustments. However, the reference in the officer definition to the dollar limitation in Section 415(c)(1)(A) was evidently intended to provide for an automatic cost of living adjustment. Because the Tax Reform Act of 1986 changes Section 415(c)(1)(A) to freeze the dollar amount indefinitely, an increase in the dollar amount in the officer component of the key employee definition in the near future is unlikely. ASAE believes that the dollar amount in the officer component of the highly compensated employee definition should be modified to be subject to cost of living adjustments to avoid the key employee definition from becoming inappropriate because of inflation, (Even though the overwhelming majority of ASAE members do not work for employers with owners, the same logic would apply to other components of the key employee definition that include or reference a dollar amount.) This can be accomplished in S. 1350 by amending the officer component of the key employee definition in Section 416(i)(1)A)(i) to reference the current $45,000 amount in effect and by amending Section 416(i)(1) of the Code to authorize the Secretary of Treasury to adjust the $45,000 amount at the same time and in the same manner as under Section 415(d) of the Code.

<u>Requested Relief</u>

ASAE requests that Congress provide in S. 1350 for a change in the officer component of the definition of "highly compensated employee" in Section 414(q) of the Code and a change in the officer component of the definition of "key employee" in Section 416(i) of the Code. These changes would specify that the applicable dollar amount is currently $45,000, and would provide that this amount is to be adjusted annually at the same time and in the same manner as the adjustment under Section 415(d) of the Code to the defined benefit plan dollar limitation.

ASAE appreciates the opportunity to present its views on this important issue. We would welcome the opportunity, should you find it helpful, to schedule a meeting with me and a representative or representatives from ASAE to discuss this issue in greater detail.

Sincerely,

SANDERS, SCHNABEL & BRANDENBURG, P.C.

Dan S. Brandenburg

Dan S. Brandenburg

BIOGRAPHICAL STATEMENT

ON THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

ASAE is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005 (202-626-2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of nearly 14,000 individuals representing more than 7,500 national, state, and local associations. The overwhelming majority of ASAE's members represent tax-exempt organizations, most of which are either tax-exempt as trade associations under Section 501(c)(6) of the Internal Revenue Code ("Code") or tax exempt as educational or charitable organizations under Section 501(c)(3) of the Code. Many of ASAE's member associations either sponsor or are contemplating sponsoring funded welfare benefit plans.

July 14, 1987

ASAE COMMENTS ON S. 1350, THE TECHNICAL CORRECTIONS ACT OF 1987

Summary

The American Society of Association Executives ("ASAE") seeks to have changes made in the dollar amount in the officer component of the definition of "highly compensated employee" in Section 414(g) of the Internal Revenue Code ("Code") and in the officer component of the definition of "key employee" in Section 416(i) of the Code. These changes would specify that the applicable dollar amount is currently $45,000, and would provide that this amount is to be adjusted annually at the same time and in the same manner as the adjustment under Section 415(d) of the Code to the defined benefit plan dollar limitation. These changes are necessary to prevent these definitions from becoming inappropriate by virtue of inflation.

SCHOOL OF THEOLOGY AT CLAREMONT

July 1, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance
S. D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I urge you to please amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by I R C Sec. 501 (C) (3) organizations are not "commercial-type insurance" under I R C Sec. 501 (M).

Gift annuities have been used by the charitable community for over 100 years and allow the small donor an avenue equivalent to the Charitable Remainder Annuity Trust, which is unaffected by Section 501 (M). Here at the School of Theology, the gift annuity enables donors to make a gift for the education of tomorrows ministers.

My understanding is that gift annuities are not "commerical-type insurance" and I have never experienced them to be in competition with commerical annuities.

Failure to obtain relief on this issue would dry up a vital source of funds for this organization.

Thank you for your leadership and your attention to this critical issue.

Sincerely,

David H. Nienas
Director of Planned Giving

DHN:kd

SCHOOL OF THEOLOGY AT CLAREMONT

July 10, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance
S. D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I am writing regarding the technical corrections bill and would like to encourage you to keep the charitable deduction in the generation-skipping transfer tax "inclusion ratio" formula.

Repealing the generation-skipping transfer tax charitable deduction for lead trusts is clearly substantive and not technical. It addition to being substantive, the change is contrary to congressional policy of encouraging charitable gifts.

Once again, thank you for your fine leadership and your attention to this matter of importance.

Sincerely,

David H. Nienas
Director of Planned Giving

DHN:kd

The School of the Ozarks

Accredited four-year college

POINT LOOKOUT, MISSOURI 65726 • TELEPHONE (AREA CODE 417) 334-6411

July 13, 1987

Ms. Laura Wilcox
US Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I am writing to you to express my concern about the possible taxation of Charitable Gift Annuities.

As Director of Planned Giving at this institution I wanted you to know the Charitable Gift Annuity has been an important instrument in fund raising to this college since we started writing them 17 years ago. We have written approximately $6,000,000.00, and if this vehicle is taken away it would ruin an important source of funds for The School of the Ozarks.

Our college is one of the many sponsors of the Committee on Gift Annuities which met in New Orleans last year. I attended this important meeting and discovered this has been vital to the charitable community for over 100 years.

Our institution also has a number of Charitable Remainder Annuity Trusts which is apparently unaffected by Section 501(m). The two instruments are both life income plans and have many of the same characteristics. All of the gift annuities with The School of the Ozarks are because a good friend has wanted to make a gift to help our cause and not so the donor could obtain annuity payments.
I would appreciate your help and rely on your leadership in clarifying the exemption of gift annuities from IRC Section 501(m). Please take into consideration what charitable organizations, such as ours, are doing with gift annuities. This vehicle relieves the federal government from having to assist these charitable organizations with funds from the national budget. We want to and need to continue using this important instrument, the Charitable Gift Annuity, in our planned giving efforts.

Most sincerely,

G. Stanley Fry

G. Stanley Fry
Director of Planned Giving

SCRIBNER, HALL & THOMPSON

William Wilkins
Majority Staff Director
and Chief Counsel
U. S. Senate Committee
on Finance
205 Senate Dirksen Office Bldg.
Washington, D.C. 20510

Re: Technical Correction to I.R.C. §832(b)(4) -- to Eliminate a Double Disallowance of Deduction for Certain Acquisition Expenses

Dear Mr. Wilkins:

We are submitting the attached document on behalf of CNA Insurance Companies, Chicago, Illinois. The document briefly describes a technical problem presented by the 20-percent adjustment to unearned premiums in I.R.C. §832(b)(4) that was adopted by Congress in the Tax Reform Act of 1986.

We believe that CNA is one of just four companies that follow the holding in Western Casualty and Surety Company v. Commissioner, 571 F.2d 514 (10th Cir. 1978) and do not deduct commissions relating to deferred premium installments when the policy is issued, although such installments are reflected in unearned premiums. The Western Casualty method of accounting combined with the recently adopted 20-percent adjustment to unearned premiums causes a double adjustment for these acquisition expenses.

Please consider this letter as written comments on S. 1350, submitted to the Senate Finance Committee for its formal consideration.

Sincerely,

Susan J. Hotine

Susan J. Hotine

SJH/kks
Enclosure

cc: Richard Meltzer
Winston & Strawn

DRAFT

Technical Correction to I.R.C. §832(b)(4)
Eliminate a Double Disallowance of Deduction for Certain Acquisition Expenses

Background

The Tax Reform Act of 1986 amended I.R.C. §832(b)(4) to provide a better matching of premium income and expenses associated with the earning of that income. Under the provision, a property/casualty insurance company generally is required to reduce its deduction for increases in unearned premiums by 20 percent. The 20-percent adjustment is intended to represent the allocable portion of expenses incurred in generating the unearned premiums. The reduction of the current deduction for unearned premiums provides a better matching because it "is equivalent to denying current deductibility for a portion of the premium acquisition expenses" -- that portion attributable to the unearned premiums (see the General Explanation of the Tax Reform Act of 1986 (1986 Blue Book), prepared by the staff of the Joint Committee on Taxation, p. 595 (May 4, 1987)).

In adopting the 20-percent adjustment to unearned premiums, Congress did statutorily what some courts had begun already. Specifically, in Western Casualty and Surety Company v. Commissioner, 571 F.2d 514 (10th Cir. 1978), 78-1 USTC ¶9220, the court denied the taxpayer a deduction for unpaid sales commissions on deferred premium installments in the year the policies were issued, even though the taxpayer showed the commissions on its annual statement as expenses incurred and reflected the deferred premium installments as part of its unearned premiums. There was a similar holding in City Investing Company v. Commissioner, 52 T.C.M. 1422 (1987). The 20-percent adjustment provides a broader range of income and expense matching, reaching not only commissions relating to deferred premium installments, but other acquisition expenses such as paid commissions and premium taxes.

The Problem

The 20-percent adjustment to unearned premiums represents the portion of expenses incurred that is allocable to generating the unearned premiums, including sales commissions on deferred premium installments. To have this adjustment combined with a direct disallowance of a current deduction for such expenses (the Western Casualty method of accounting) results in a double disallowance of a current deduction (or a double adjustment).

To our knowledge there are no more than four companies which are using the "Western Casualty method of accounting" for commissions relating to deferred premium installments -- that is, not deducting those commissions when the policy is issued. It would be unfair to disadvantage the few companies that have acquiesced in following the Western Casualty decision.

Proposed Technical Correction

The 20-percent adjustment to unearned premiums should be reduced by the amount of any sales commissions/expenses directly disallowed by the application of the Western Casualty method of accounting.

Revenue Discussion

The legislative history of the provision adopting a 20-percent adjustment to unearned premiums indicates that Congress assumed that all premium acquisition expenses, including commissions attributable to unearned premiums, were included in "expenses incurred" and deductible currently. See H. Rep. 99-426, 99th Cong., 1st Sess. 668 et seq. (1985); S. Rep. 99-313, 99th Cong., 2d Sess. 495 et seq. (1986); the 1986 Blue Book, pp. 594 et seq. In fact, with the exception of only a few companies, this assumption was true.

By reducing the unearned premium deduction (and accelerating the recognition of premium income), the 20-percent adjustment was intended to result in a better matching of income and expenses. There was general recognition that the reduction of unearned premiums is equivalent to denying current deductibility for a portion of the premium acquisition expenses -- that is, the portion attributable to unearned premiums.

The overall revenue estimate for the property/casualty industry would not have assumed a double disallowance of a current deduction for commissions relating to such deferred premium installments. Thus, the proposed technical correction should be revenue neutral. Or, in the alternative, because there are only a few (four to our knowledge) companies that use a Western Casualty method of accounting, the revenue for the proposed technical correction to the 20-percent adjustment provision should be de minimis.

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Direct Line: 619 457-8288

July 22, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I wish to protest the potential repeal of the charitable deduction as an offset against the generation-skipping transfer tax (GSTT) on charitable lead trusts.

Scripps Clinic and Research Foundation was founded in 1924 and is one of the oldest, privately operated, non-profit medical institutions in the west. It's activities integrate basic and clinical research, medical care, and advanced medical education. While tax benefits, in my estimation, are not the primary reason why individuals give to charitable institutions as ours, they are undeniably an influencing factor. Without the generosity of many thoughtful individuals our institution and many others throughout our country would find it difficult to survive.

Our nation's philosophy has always encouraged giving to causes that ultimately benefit the communities in which we reside. Relying on this heritage, I ask that in computing the GSTT the charitable deduction continue to be used.

Thank you for your consideration in this matter.

Sincerely,

Adam R. Smalley

Adam R. Smalley

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Office of University Advancement

Seattle Pacific University
Seattle, Washington 98119
Phone: (206) 281-2100

July 7, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I am writing to urge you to amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial type insurance" under IRC Sec. 501(m).

For more than a century, gift annuities have been used by charitable organizations to raise needed funds. They are one of the most popular gift vehicles for elderly folk and for those who are unable to make large donations.

Gift annuities do not compete with commercial annuities and are not "commercial type insurance." People use these gift vehicles because they want to give to our institution, not because they are seeking to benefit themselves.

Seattle Pacific University and other quality independent higher education institutions are needed as never before to provide strong leadership for our country. With expenses climbing at an alarming rate, we desperately need a growing amount of financial support. If we lose the gift annuity as a tool for giving, we will lose important support. It would not only be a blow for us, it would also be detrimental to our country.

Please do everything you can to see that gift annuities are retained as a vehicle for charitable giving.

Sincerely,

G. Roger Schoenhals
Director of the
Seattle Pacific Foundation

GRS/jmh

STATEMENT OF THE SECTION 457 TASK FORCE BEFORE THE SUBCOMMITTEE OF TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEEE

Summary of Accompanying Written Comments of the Section 457 Task Force Regarding the Technical Corrections Act of 1987 and Internal Revenue Code Section 457

Section 1107 of the Tax Reform Act of 1986 (the "1986 Act") extended Internal Revenue Code section 457 to certain deferred compensation plans of tax-exempt employers. Section 457, as enacted in 1978, formerly applied only to deferred compensation plans of state and local governments and their agencies or instrumentalities (e.g., a state university).

Although the 1986 Act expanded the group of employers subject to section 457, there was no indication by Congress that the substantive scope of section 457 had been changed. Nevertheless, the Internal Revenue Service ("IRS") has taken a public position in Notice 87-13 that the types and nature of deferred compensation plans governed by section 457 include nonelective deferred benefit plans (e.g., vacation pay plans, severance pay plans and nonelective retirement pay plans) which generally had been thought to be outside the scope of the section 457 rules (as they previously applied to state and local governments).

A clear statement through the Technical Corrections Act of 1987 (H.R. 2636) is required to negate the overbroad interpretation of section 457 taken by the IRS. The accompanying written comments briefly summarize the legislative history of section 457 and highlight the need for legislative clarification that section 457 does not extend to nonelective deferred compensation of tax-exempt organizations and state and local government employers.

In the event any questions arise regarding these written comments, contact the following designated representative of the individuals and organizations for whom the comments are being submitted:

Designated Representative of the Section 457 Task Force*:

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* Attached is a list of the members of the Section 457 Task Force. The Church Alliance supports the position of the 457 Task Force. See the attached letter from Gary Nash, the Church Alliance Secretary, to Kenneth J. Kies.

Mr. Chairman, my name is Ken Kies. I am a partner with the law firm of Baker & Hostetler. I appear in my capacity as the designated representative of The Section 457 Task Force, a coalition of state and local government employers and private tax-exempt employers. This coalition believes that the IRS has incorrectly interpreted a provision of the Tax Reform Act of 1986 as it applies to employees of state and local government and private tax-exempt employers. The coalition urges the Congress to reverse this erroneous interpretation through the techncial correction process.

I. Background.

Section 1107 of the Tax Reform Act of 1986 (the "1986 Act") broadens the coverage of section 457 of the Internal Revenue Code (the "Code"). As a result, certain deferred compensation plans of tax-exempt organizations (other than state and local governments which were subject to section 457 before the 1986 Act) are subject to new rules. Generally, amended section 457 applies to tax-exempt organizations for taxable years beginning after December 31, 1986, although many existing plans are grandfathered under some circumstances for existing employees.

Tax-exempt organizations have expressed concern regarding the treatment of nonelective, nonqualified retirement plans (and other nonelective, employer-provided deferred benefits) under section 457. Likewise, state and local government employers have expressed similar concerns over the public position only recently taken by the Internal Revenue Service ("IRS") in Notice 87-13 regarding the scope of section 457 as originally enacted in 1978. The IRS position overstates the intended scope of section 457. This overstatement, in many cases, would require employees to pay tax on deferred benefits which such employees have no right to receive currently (and may never receive). In the case of affected state and local government employers, the IRS interpretation, if correct, probably requires an amendment to W-2 forms for affected employees and a concurrent amendment of such employees tax returns for all open tax years.

To allay the foregoing concerns and to reverse the erroneous IRS position, it is necessary to clarify the intended scope of section 457 in the Technical Corrections Act of 1987 (H.R. 2636). The balance of this memorandum discusses Code section 457 in the context of its legislative history, and explains why the general scope of section 457 which was not changed by the 1986 Act, should remain limited to non-qualified, elective deferred benefit arrangements. Nonqualified, nonelective retirement pay plans (as well as other nonelective deferred benefit plans) of both tax-exempt and state and local government employers should remain unaffected by section 457 in accordance with clear Congresssional intent.

II. Inapplicability of Section 457 to Nonelective, Non-Qualified Deferred Benefit Plans.

A. Deferred Compensation Rules Before 1978; Constructive Receipt Rule.

Prior to 1978, nonqualified deferred compensation arrangements were subject to broad statutory guidelines and regulations. A cash-basis employee included deferred amounts in income when those amounts were "actually or constructively received." Treas. Reg. 1.446-1(c)(1)(i); See also I.R.C. 451; Treas. Reg. 1.451-2 (constructive receipt of income). IRS administrative rulings further defined the income recognition rules for various nonqualified deferred compensation arrangements. See, e.g., Rev. Rul. 60-31, 1960-1 C.B. 174 (guidelines for applying rule of constructive receipt to deferred compensation arrangements), modified, Rev. Rul. 70-435, 1970-2 C.B. 100 (replacing one factual example). Under traditional constructive receipt principles, deferred amounts are not taxed currently unless they are "made available" to the taxpayer so that the taxpayer can elect to receive such amounts currently. See, e.g., Metcalfe v. Commissioner, 43 T.C.M. (CCH) 1393, 1396 (1982).

B. Proposed Regulation Section 1.61-16.

In 1978, the IRS published Proposed Regulation section 1.61-16 (the "Proposed Regulation"), which would have eliminated the ability of employees to defer compensation at their individual option. See 43 Fed. Reg. 4638 (Feb. 3, 1978). Specifically, the Proposed Regulation would have required all cash-basis taxpayers covered by elective, nonqualified deferred compensation arrangements to recognize deferred amounts as income in the taxable year such amounts otherwise would have been payable, rather than in the later taxable year when the deferred amounts actually were paid.

By its terms, however, the Proposed Regulation only affected those amounts deferred "at the taxpayer's individual option." Id. Thus, nonelective, nonqualified retirement plans that basically consisted of deferred commitments to pay benefits pursuant to a formula or schedule were not the target of the Proposed Regulation. Since the benefits under such plans were not attributable to amounts deferred "at the taxpayer's individual option," they would not have been covered by the Proposed Regulation. Thus, under established income recognition rules, employees would not be taxed on nonelective unfunded retirement benefits until payments actually were made.

The Proposed Regulation was designed primarily to eliminate elective deferral arrangements for state and local government employees (although, by its terms, it applied to elective deferral arrangements of all taxpayers). See, e.g., Fischer, Deferred Compensation: Born Again -- for Now, 37 N.Y.U. Inst. on Fed. Tax'n 28-1, 28-8 to 12 (1979) (discusses history of Prop. Reg. 1.61-16).

C. Congressional Response to the Proposed Regulation.

Congressional response was swift. Sections 131 and 132 of the Revenue Act of 1978 (the "1978 Act") specifically addressed most elective deferred compensation arrangements jeopardized by the Proposed Regulation. See Public Law 95-600, 92 Stat. 2779-83 (Nov. 6, 1978), reprinted in 1978-3 C.B. 13-17; see also H.R. Rep. No. 1445, 95th Cong., 2d Sess. 52-53, reprinted in 1978-3 C.B. 226-27 (reasons for change); S. Rep. No. 1263, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 363 (reasons for change); H.R. Rep. No. 1800, 95th Cong., 2d Sess. 65, reprinted in 1978-3 C.B. 538 (reasons for change).

Section 131 of the 1978 Act created Code section 457, which applied to State and local government deferred compensation plans. Section 132 of the 1978 Act rejected application of the Proposed Regulation to deferred compensation plans of private, taxable employers. In section 132(a) of the Act, Congress pronounced that the legal principles governing private deferred compensation plans would be those in effect on February 1, 1978 (two days before publication of the Proposed Regulation). Id. at 92 Stat. 2782-83, reprinted in 1978-3 C.B. 16-17.

D. Statutory Language and 1978 Legislative History Behind Section 457.

Section 457, by its terms, contemplates elective deferrals. See I.R.C. 457(b)(4) (agreement or arrangement providing for deferral); Treas. Reg. 1.457-2(b), 2(g) (same). Within the context of section 457, the very concept of "deferred compensation" presupposes a right or option to receive economic benefits currently, which benefits are deferred by agreement.

The legislative history confirms without ambiguity that the limitations on "deferred compensation plans" of state and local governments were never intended to apply to nonqualified retirement pay plans which were unfunded and nonelective (i.e., employer-provided retirement plans with no elective or salary-reduction features):

> The treatment provided by [section 457] for an ineligible State deferred compensation plan extends only to plans which provide an option to defer compensation and is inapplicable to a State's regular retirement system (whether or not such plan is a tax-qualified plan) which does not provide such an option.
>
> [H.R. Rep. No. 1445, 95th Cong. 2d Sess. 57, reprinted in 1978-3 C.B. 231 (emphasis added).]
>
> The tax treatment of participants in an ineligible State deferred compensation plan does not extend to participants in the State's regular retirement plan (whether or not qualified under 401(a)).
>
> [S. Rep. No. 1263, 95th Cong., 2d Sess. 70, reprinted in 1978-3 C.B. 368 (emphasis added).]

When discussing the effect of section 457 on tax revenues, both the House and Senate Reports affirmed that section 457 continued "the existing tax treatment" of deferred compensation plans "within certain limitations." See H.R. Rep. No. 1445 at 58, reprinted in 1978-3 C.B. 232; S. Rep. No. 1263 at 71, reprinted in 1978-3 C.B. 369.

Section 457 was a response to the Proposed Regulation which addressed only elective deferral arrangements which were the subject of that Regulation. Both the House and Senate Reports regarding section 457 consistently referred to elective or contractual deferral arrangements. Further, there is no discussion in the legislative history to indicate that unfunded welfare benefit plans (e.g., sick pay or vacation pay plans, survivor benefit plans or severance pay arrangements) were ever intended to be subject to the "deferred compensation" rules of section 457.

In effect, sections 131 and 132 of the 1978 Act were designed to permit elective deferrals by State and local government employees within specified limitations and unlimited elective deferrals by other employees. The Congress thereby retreated from the position taken in the Proposed Regulation, which would have required current income recognition of all elective deferrals. No change had ever been suggested, either in the Proposed Regulation or in section 457, regarding the tax treatment of unfunded, nonelective deferred benefits (e.g., regular retirement plans, welfare benefit plans or survivor benefit plans). Thus, section 457 was clearly intended to be a relief provision.

Two other provisions of the 1978 Act also dealt with employee elections and their effect on current taxable compensation. 1978 Act Sections 134 and 135 created Code sections 125 (cafeteria plans) and 401(k) (cash or deferred arrangements), respectively. See Public Law 95-600, 92 Stat 2783-87 (Nov. 6, 1978), reprinted in 1978-3 C.B. 17-21. Neither Code section 125 nor Code section 401(k) refers to section 457, but all three of those sections impose limitations on an employee's ability, by agreement or election, to avoid or defer taxation on certain forms of employee benefits. In fact, Code section 125 was coordinated indirectly with section 457, since "deferred compensation plans" were excluded from the general cafeteria plan provisions. See id. at 92 Stat. 2784 (Code section 125(d)(2)), reprinted in 1978-3 C.B. 18.

It has been suggested that the absence in section 457 of words like "elect" or "choose" (which are used in sections 125 and 401(k)) manifests that Congress did not intend to limit section 457 to elective deferred benefits. But section 457 consistently refers to "agreements" or "arrangements" by employees to defer compensation. A reference in section 457 to "elective" deferred compensation would have been redundant. Therefore, especially when read in light of its legislative history, it seems clear that section 457 should apply only to elective unfunded deferrals.

E. Confusion Regarding the Scope of Section 457.

Despite clear indications that section 457 applied only to elective deferrals (e.g., salary reduction arrangements), the elective/nonelective distinction was either ignored or forgotten in some instances.

One of the first sources of confusion is the Joint Committee's General Explanation of the Revenue Act of 1978 (the "1978 Blue Book"). The 1978 Blue Book accurately summarizes the history behind section 457 and the reasons Congress chose to limit deferred compensation arrangements for State and local government employees, citing the concern over "plans involving an individual election to defer compensation." See id. at 68. But the 1978 Blue Book's "Explanation of Provision" contains the following statement about section 457:

> The rules prescribed by the Act apply whether or not exployees [sic] and independent contractors are provided with an individual option to defer. [Id.]

While it is not clear with respect to what the above-quoted language has reference, it cannot be interpreted to mean that nonelective deferred benefits are subject to section 457 without being in direct conflict with the legislative history of the 1978 Act with respect to section 457.

A few years later, apparently due to some uncertainty as to the IRS's position regarding the application of section 457 to unfunded retirement plans, a provision which explicitly exempted certain nonelective judicial retirement plans from the section 457 rules was incorporated into the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). See TEFRA section 252, retroactively amending section 131(c) of the 1978 Act (enabling provisions of Code section 457). Although such nonelective plans should not have been affected by section 457 in any event, the Texas state judges sought to secure an ironclad statutory exemption and succeeded.

The "Reasons for Change" in the Senate Report confirmed that the contribution limits and rules of Code section 457 should not be applied to State judges' unfunded "defined benefit" retirement plans which had no elective features:

> Because the participant's benefit under such a [retirement] plan generally does not depend upon the participant's account balance, the committee believes it is inappropriate to apply contribution limits or other rules designed for defined contribution plans.
>
> [S. Rep. No. 494, 97th Cong., 2d Sess. 328 (1982).]

Unfortunately, the Senate Report suggested a defined-contribution/defined-benefit distinction as the line of demarcation for "appropriate" application of section 457. The elective/nonelective distinction was temporarily submerged.

Shortly after TEFRA was enacted, the ~~Department of~~ Treasury ("Treasury") issued final Regulations for Code section 457. While the Regulations themselves did not explicitly address the elective/nonelective issue, the preamble to those Regulations contained the following statement:

> [I]n the absence of statutory authority to provide for the exclusion of [unfunded regular retirement] plans from section 457(e)(1) and without clearer legislative guidance as to what form this exclusion should take, it has been decided that it is inappropriate to provide for this exclusion through regulations. Consequently, deferrals under an unfunded regular retirement plan of a State will be considered to be made under an ineligible plan, and not excludible from income under section 457(a).
>
> [47 Fed. Reg. 42336 (Sept. 27, 1982).]

Ignoring the ample legislative history indicating that nonelective, unfunded retirement plans are outside the ambit of section 457, Treasury suggested that all unfunded deferred benefit plans (except those specifically enumerated in section 457(e)(1)) had been swept away under the guise of section 457. Apparently, Treasury was unwilling to make an elective/nonelective distinction notwithstanding the presence of legislative history which indicated that section 457 was intended to apply only to elective deferral arrangements. No attempt was made to incorporate this provision into the regulations, evidencing apparent uncertainty on the part of the Treasury with respect to its own position.

F. The 1986 Act.

The 1986 Act originated from The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985)("President's Proposal"). The President's Proposals included the proposed extension of section 457 to all tax-exempt employers. As described in the President's Proposals, the change in section 457 would affect elective deferrals by employees:

> . The rules permitting the elective deferral of compensation by employees of States on a nonqualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code. Thus, an employee of a tax-exempt employer would be permitted to defer, on an elective basis and subject to the same limitations currently applicable to State employees a portion of his or her current compensation under a nonqualified and unfunded arrangement maintained by the employer (an "eligible deferred compensation plan"). Compensation deferred by an employee of a State or tax-exempt employer under an ineligible deferred compensation plan would be includible in the employee's gross income when there is no longer a substantial risk of forfeiture.
>
> [President's Proposal, Chapter 14.10 at 381 (emphasis added).]

There is no indication that Code section 457, as then in effect, was understood to apply to anything but elective deferral arrangements. In fact, the tenor of Treasury's description of the changes suggests that the employees of the tax-exempt community would be receiving a benefit from the extension of section 457, a suggestion clearly inconsistent with an extension of section 457 to nonelective deferred compensation.

Generally adopting the President's Proposals, the 1986 Act extended section 457 rules to tax-exempt employers. 1986 Act section 1107, H.R. Rep. No. 841, 99th Cong., 2d Sess. at I-361 to 366. The operative language of section 457 remained substantially the same, except for the deferral coordination rules of section 457(c) and the new distribution rules of section 457(d).

The Conference Report accompanying the 1986 Act gives no indication of any Congressional intent to expand the scope or nature of plans encompassed by section 457. See id. at II-397 to 400. And the Joint Committee's General Explanation of the

Tax Reform Act of 1986 (the "1986 Blue Book"; published May 4, 1987) confirms that section 457 "continues to apply to the same types of deferred compensation to which it applied under prior law." Id. at 654. Thus, although the 1986 Act expanded the group of employers affected by section 457, it did not change the type or nature of deferred compensation plans subject to the section 457 rules.

The same types of nonelective, unfunded retirement plans maintained by state or local governments which always were beyond the intended scope of section 457 similarly should remain beyond the scope of amended section 457 as it applies to such plans maintained by tax-exempt organizations. For example, nonqualified, nonelective retirement pay plans with no salary reduction features should remain unaffected by section 457, whether they are maintained by governmental entities or tax-exempt organizations.

III. Notice 87-13 and Examples of Plans to which Section 457 Should Not Apply.

On January 5, 1987, the IRS released Notice 87-13 (published January 26, 1987 in Internal Revenue Bulletin No. 1987-4), which contained the preliminary IRS views regarding the scope and application of Code section 457. At Q&A-26, the IRS adopted the following position:

> Section 457 applies to amounts deferred under a deferred compensation plan regardless of whether the plan is in the nature of an individual account or defined contribution plan or a defined benefit plan, including a deferred compensation plan that provides benefits in excess of the benefits provided under a qualified plan under section 401(a), a deferred compensation plan that provides benefits in excess of the benefits permitted to be provided under a qualified plan on account of section 415, and a deferred compensation plan that provides benefits only to a select a group of executives or other highly compensated employees (e.g., a "top hat" plan). Also, section 457 applies to amounts deferred even though deferred amounts are determined by reference to factors other than the annual compensation of the individual (e.g., years of service, final average salary), uncertain in aggregate amount, and are payable over an indeterminable period (e.g., over the life of the individual).
>
> Section 457 applies to amounts deferred under a deferred compensation plan, whether or not such deferral is pursuant to the election of the individual taxpayer. Thus, section 457 applies to both elective and nonelective deferred compensation amounts.
> [1987-4 I.R.B. at 26.]

The extreme position adopted by the IRS disregards the historical distinction between the tax treatment of employee elective deferrals and employer-provided, nonelective deferred benefits.

The IRS position threatens many unfunded retirement programs and other benefit programs (e.g., vacation pay and sick pay plans) maintained by tax-exempt organizations and State and local governments. It is understood that some State and local government employees participate in both (i) an "eligible deferred compensation plan" under section 457 (which generally permits elective deferrals up to $7,500 per year), and (ii) a nonelective unfunded retirement plan which provides an annuity form of retirement benefit based upon years of service and final average compensation. The IRS apparently intends to treat such retirement plans as "ineligible" plans subject to section 457. Such an interpretation could result in the retroactive taxation of benefits "accrued" under such retirement plans since as far back as 1978.

Section 457 contemplates agreements by employees with employers whereby limited elective deferrals may be made with favored tax treatment. Thus, section 457 should properly be interpreted to affect only unfunded salary reduction agreements whereby an employee elects to forego current compensation in exchange for unfunded future payments.

IV. Revenue Impact and Administrative Concerns

State and local governments have administered elective deferred benefit plans under section 457 since 1978. Under the 1986 Act, the same rules limiting elective deferrals will apply to tax-exempt employers. The suggested legislative clarification would explicitly exclude nonelective deferral arrangements from the section 457 rules. Since such nonelective arrangements never were intended to provide revenue under section 457, their continued exclusion should have no adverse impact on projected tax revenues.

On the other hand, the unwarranted interpretation of section 457 adopted by the IRS would result in current taxation of nonelective deferred benefits. Employees of both tax-exempt organizations and state and local governments would have to recognize as current income the "present value" of hypothetical deferred benefit "accruals." The accurate valuation of these accruals would be virtually impossible in many cases. If the employee did forfeit benefits or if the employer became insolvent before the nonelective deferred benefits were paid, such employees would have paid tax on income never received and with respect to "benefits" over which they had no control or right to demand current payment. Such treatment would be totally at odds with the entire history of the Federal individual income tax system under which individual taxpayers are taxed on the cash basis method of accounting.

Affected employers would confront administrative nightmares coordinating elective and nonelective deferred benefit plans if both involuntary "accruals" and elective employee deferrals were subject to section 457 limits. Further, employees would perceive the current taxation of deferred income over which they have no control as grossly unfair.

V. Conclusion.

In light of the IRS pronouncement in Notice 87-13, the Congress should now take the opportunity to clearly state that section 457 does not apply to nonelective deferred compensation. As a part of that process, the distinction between elective and nonelective deferrals also could be clarified, most easily through illustrations and examples made part of the legislative history. The Section 457 Task Force is prepared to work with the Ways and Means Committee to assist in any way with this effort.

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National Association of Counties
Represented by: Mr. Larry Jones
Legislative Representative
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Washington, D.C. 20001

Business Council of Georgia
Represented by: Mr. Gene Dyson
President
Business Council of Georgia
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CHURCH ALLIANCE

ACTING ON BEHALF OF CHURCH PENSION PROGRAMS

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July 14, 1987

Mr. Kenneth J. Kies
Baker & Hostetler
Washington Square, Suite 1100
1050 Connecticut Avenue, N.W.
Washington, D.C. 20036

Re: Section 457 Task Force - Technical Corrections Act of 1987

Dear Mr. Kies:

Representatives of the Church Alliance have reviewed the materials that you will be forwarding to the Ways & Means Committee on behalf of the Section 457 Task Force, and we are in hearty agreement with the relief that you are requesting therein. The Church Alliance has submitted its own comments on the section 457 issue, and the Church Alliance also submits that section 457 has never covered, and should not cover, nonelective deferred compensation arrangements.

We in the Church Alliance look forward to working closely with you and the other members of the Section 457 Task Force to make sure that nonelective deferred compensation arrangements are preserved for the 28 mainline denominations represented through the Church Alliance.

Sincerely yours,

Gary S. Nash

Gary S. Nash,
Church Alliance Secretary

Sea-Land Corporation

Suite 560 • National Place • 1331 Pennsylvania Avenue, N.W. • Washington, D.C. 20004 • (202) 783-1117

July 21, 1987

The Honorable Max Baucus
Chairman, Taxation
and Debt Management Subcommittee
Committee on Finance
United States Senate
205 Dirksen Building
Washington, D.C. 20510

Dear Mr. Chairman:

Sea-Land Corporation is pleased to submit comments on S.1350, the Technical Corrections Act of 1987. We request that our views be made part of the Hearing Record to be established by your Subcommittee on July 22.

Sea-Land Corporation, a unit of CSX Corporation, is a world leader in international intermodal freight transportation and related trade services. Our principal operating subsidiary, Sea-Land Service, Inc., today operates a fleet of U.S.-flag containerships and other vessels which serve all major ports in the United States.

As our business depends directly on the free flow of cargo over these ports, we followed with keen interest the debate over the Water Resources and Development Act of 1986 (P.L. 99-662). As you know, the Finance Committee approved one title of that new law which authorized a .04 percent harbor maintenance tax on import/export cargo for the purpose of funding a portion of the costs associated with operating and maintaining ports and waterways. This tax is to be paid by the shipper of the cargo directly to the federal government.

It since has come to our attention that this tax will be applied twice to cargo which is relayed over a second port en route to its final destination if that cargo is transferred to a different vessel at the relay port.

Sea-Land, as well as many other ocean carriers serving the U.S. foreign commerce, has employed for some years a relay system between U.S. ports in order to provide the fastest, most economical service possible to our customers. Relay services have been incorporated both in export and import trades as an integral part of Sea-Land's operating logistics at ports where volume or economics will not support a line haul vessel call. As a particular example, Sea-Land serves the ports of Boston and Baltimore via feeder barge relaying to its principal U.S. East Coast terminal at Port Elizabeth, N.J. On the West Coast, all exports from Alaska to the Far East are relayed through Sea-Land's terminal at Tacoma, Washington. These services reflect Sea-Land's continued efforts to hold down costs and to provide competitive service.

An ancillary benefit, we believe, is that these services place the least demand possible on the harbors were they are employed, as barges draw about six to nine feet of water as compared to 35 feet or more for a large containership. This, in turn, reduces the demand for scarce federal dollars needed to create deep draft ports.

We believe our industry has been encouraged by various government policies to develop and offer the kind of innovative transportation option which relay services represent. Yet, if the harbor maintenance tax cited above is imposed twice on cargo utilizing this service, it could jeopardize the service to the ultimate detriment of the U.S. consumer and exporter. Moreover, we believe it is inherently unfair to ask a shipper, whether an importer or an exporter, to pay the same tax twice on the same cargo.

We also believe that Congress could not have intended this result. In Section 4461 (g)(1) of the Act, under the title "Tax Imposed Only Once", Congress provided that cargo should not be taxed twice when taken off and put back on the same vessel at a U.S. port. Thus, if one vessel called Port Elizabeth first on an import voyage and then proceeded on to Boston where certain cargo was unloaded, only one charge would be assessed. This is true even if, for the carrier's convenience, the cargo was taken off and put back on that vessel at Port Elizabeth. But if instead of being placed back on the first vessel it was placed on a barge for carriage to Boston, two charges would apply. We do not believe that Congress intended such an anomaly.

For these reasons, we are seeking an amendment to the law that would make clear the harbor maintenance tax should apply only once to import/export cargo, whether or not the cargo is relayed on a different vessel for the final leg of its journey. Legislative language to accomplish this objective is attached for your convenience. We respectfully request that it be included as an amendment to the Technical Corrections Act when that measure is considered by the Committee on Finance at mark-up.

If we can answer any additional questions about our service or our views on this issue, I hope you will not hesitate to contact me.

Sincerely,

Rebecca J. Berg
Director, Federal Public Affairs

Attachment

SECTION 1. HARBOR MAINTENANCE TAX TO APPLY ONLY ONCE TO CARGO ENTERING OR LEAVING THE UNITED STATES IN A CONTINUOUS TRANSPORTATION BY A SINGLE SHIPPER.

(a) IN GENERAL.--Subsection (g) of section 4462 of the Internal Revenue Code of 1986 (relating to definitions and special rules for harbor maintenance tax) is amended by adding at the end thereof the following new paragraph:

``(3) CARGO ENTERING OR LEAVING THE UNITED STATES.--

``(A) IMPORTS.--In the case of cargo which entered the United States and on which tax under section 4461(a) was paid by the importer, no tax shall be imposed under such section on any subsequent loading or unloading of such cargo if--

``(i) the shipper of such cargo at the time of entry and at the time of such subsequent loading or unloading is the same, and

``(ii) such subsequent loading or unloading is in connection with the continuous transportation of such cargo to its ultimate destination in the United States.

``(B) EXPORTS.--In the case of cargo which is destined for export and on a loading or unloading of which tax was imposed under section 4461(a), no tax shall be imposed under such section on any subsequent loading or unloading of such cargo if--

``(i) the shipper of such cargo at the time such tax was imposed and at the time of such subsequent loading or unloading is the same, and

``(ii) such subsequent loading or unloading is in connection with the continuous transportation of such cargo to its ultimate destination outside the United States.''

(b) EFFECTIVE DATE.--The amendment made by subsection (a) shall take effect as if included in the amendments made by section 1402 of the Harbor Maintenance Revenue Act of 1986.

Seidman & Seidman | BDO
15 Columbus Circle, New York, New York 10023 (212) 765-7500, TLX 661 903

July 14, 1987

Ms. Laura Cox
Hearing Administrator
U. S. Senate
Committee on Finance -- Rm. SD-205
Washington, D.C. 20510

Re: 1987 Technical Corrections Bill (S. 1350)

Dear Ms. Cox:

Section 102(a) of the 1986 Tax Reform Act amended Section 63 of the 1986 Internal Revenue Code to provide that, in the case of an individual for whom a personal exemption deduction is allowable on another taxpayer's return, the individual's standard deduction is limited to the greater of $500 or the individual's earned income. This limitation causes two taxpayers with the same amount of unearned income to be treated differently if one of them also has earned income.

If this unfair result is unintended, Code Section 63(c)(5) should be corrected to limit the standard deduction in this situation to the greater of--

(A) $500, or

(B) the individual's earned income <u>plus $500</u>. (Suggested correction underscored.)

Respectfully,
SEIDMAN & SEIDMAN/BDO

Mario P. Borini

Mario P. Borini, CPA, PhD
National Director of
Tax Practice

TRUST SERVICES

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General Conference of
Seventh-day Adventists

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Ms. Laura Wilcox
U.S. Senate Committee on Finance
SD 205
Washington DC 20510

Dear Ms. Wilcox:

Subject: Charitable gift annuities are not the same as commercial-type insurance annuities.

The Technical Corrections Act of 1987 (H.R. 2636) should be amended to clarify the charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec 501(m).

The Seventh-day Adventist Church membership in the United States is over 600 thousand. The church is known for its charitable work through its hospitals, clinics, and community service centers. Of course, much of the medical work is self-supporting; but our charitable work and our educational programs could be curtailed if donations through charitable gift annuities were diminished due to taxation. I'll explain briefly a charitable gift annuity.

In the event a donor does not have sufficient funds to make a large outright gift, the charitable gift annuity gives the donor a specific interest income based on his age at the time the gift is made. The income is paid to him by the church for his lifetime. The rate of return is established by the national organization of churches known as the Committee on Gift Annuities, 186 Broadway, New York, New York 10023. The return is based on approximately one-half gift and one-half as the annuity. We have not seen any evidence that this type of gift and annuity is in any way competing with commercial-type insurance.

This brief letter is to solicit your support to clarify the law. Failure to do so may dry up an important source of funds for the Seventh-day Adventist Church and curtail its charitable activities. This source of support has been used by the church organization for over 50 years, and we hope its use will not be curtailed by taxation.

Thank you for your support as you work with your fellow committee members.

Sincerely yours,

Wyman S. Wager

Wyman S. Wager, Associate Director
Trust Services

mcf

SEWARD & KISSEL

July 23, 1987

Statement of Seward and Kissel to the
Senate Finance Subcommittee on Taxation
and Debt Management In Support of a Technical
Amendment to Section 1214 of the Tax Reform Act of 1986

Introduction

Pursuant to the request by the Senate Finance Subcommittee on Taxation and Debt Management for written Statements concerning S.1350, the Technical Corrections Act of 1987 (the "Technical Corrections Act"), we are submitting this Statement in support of a technical amendment to Section 1214 of the Tax Reform Act of 1986 (the "Act") on behalf of Daily Dollar Reserves, Inc., ("DDR"), a diversified, open-end investment company that has elected to be taxed as a "regulated investment company" ("RIC") for federal income tax purposes. Section 1214 of the Act amended sections 861(c), 871(i) and 881(d) of the Internal Revenue Code to change the rules regarding the determination of whether dividends and interest paid by certain domestic corporations to their foreign shareholders are derived from sources within or outside the United States. Cne unintentional consequence of this change was the elimination of the U.S. withholding tax exemption for dividends paid to foreign shareholders by United States mutual funds qualifying as so-called "80-20 corporations" prior to the adoption of the Act.

Under the prior law, dividends paid by a United States corporation to its foreign shareholders were entirely exempt from United States withholding tax if the corporation derived more than 80 percent of its aggregate gross income for a specified period from sources outside the United States (an "80-20 Corporation"). DDR and several other United States RICs qualified as 80-20 Corporations under prior law because they invest substantially all their assets in foreign bank deposits and other foreign debt obligations. While the investments of these RICs are managed by domestic investment advisers, the shareholders of the RICs are predominantly foreign entities and other nonresidents who would not be subject to United

States withholding tax if they invested directly in the foreign debt obligations owned by the RICs, rather than using the RICs as a conduit for such investments.

Subject to a transitional rule, Section 1214, by changing the basis for determining the source of dividends paid by 80-20 Corporations, inadvertently precludes RICs that would have qualified as 80-20 Corporations under the law prior to adoption of the Act from now qualifying for an exemption from United States withholding tax on dividends paid to their foreign shareholders. Once the transitional rule has expired, these RICs likely will be unable to retain their foreign shareholders and, therefore, will probably either dissolve or move off-shore if the Act is not amended to restore the exemption from United States withholding tax.

Attached to this Statement is an exhibit containing two alternative technical amendments to Section 1214 of the Act that have been proposed by Congressman Robert T. Matsui to correct the error. The remainder of this Statement will discuss the operation of Section 1214, the proposed alternative technical amendments, and certain issues concerning alleged "tax treaty shopping" that have been raised by the Treasury Department with respect to these amendments.

Discussion of Section 1214

Section 1214 of the Act generally repeals the special statutory sourcing rules previously applicable to 80-20 Corporations and treats all dividends paid by a United States corporation as United States source income. Section 1214 nevertheless provides that such dividends will continue to be exempt from the United States withholding tax imposed on certain categories of United States source income (1) if at least 80 percent of the aggregate gross income derived by the corporation during a specified "testing period" consists of "active foreign business income," and (2) only to the extent that the gross income derived by the corporation during this period consists of foreign source income. The term "active foreign business income" is defined for this purpose to mean gross income which is "attributable to the active conduct of a trade or business in a foreign country." While no clear guidance on this definition is provided in the Act or the legislative history thereof, based on our understanding of the operations of the RICs described above, it appears unlikely that these RICs would be treated as engaged in the "active" conduct of a business outside of the United States for this purpose.

Section 1214 of the Act also provides a special transitional rule with respect to this "active foreign business" exception. With respect to determining the extent to which a United States withholding tax would be imposed on dividends paid by an 80-20 Corporation to a foreign shareholder in a taxable year of such corporation beginning before January 1, 1988, this transitional rule eliminates the requirement that at least 80 percent of the income of the 80-20 Corporation must consist of "active foreign business income". This transitional rule has the effect of continuing for a short time period the special income source rule existing under prior law for dividends paid by 80-20 Corporations to foreign shareholders.

There is no indication in either Section 1214 of the Act or its legislative history that Congress intended to impose a United States withholding tax on dividends paid to foreign shareholders by an 80-20 Corporation where the income derived by the 80-20 Corporation would not have been subject to such a tax if derived directly by those shareholders. The legislative history of the Act indicates that Section 1214 of the Act was enacted primarily to address Congress' concerns that (1) the special income sourcing rules previously applicable to dividends and interest paid by 80-20 Corporations ceded primary tax jurisdiction away from the United States for income that should have borne a United States tax, and (2) certain United States taxpayers were utilizing 80-20 Corporations to artificially inflate their available foreign tax credits. See, e.g., Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 pp. 937-938. Neither of these concerns exist with respect to dividends paid to their foreign shareholders by RICs qualifying as 80-20 Corporations.

Discussion of Proposed Technical
Amendments to Section 1214 of the Act

The two alternative amendments to Section 1214 of the Act that have been proposed by Congressman Matsui would expressly continue the prior United States withholding tax exemption for dividends paid to foreign shareholders by RICs qualifying as 80-20 Corporations, at least to the extent of the foreign source income derived by a RIC during the three-year period ending with the taxable year within which the dividends are distributed. These amendments would not alter the other provisions of Section 1214 which generally treat dividends and interest paid by 80-20 Corporations as income derived from sources within the United States for all other Federal income tax purposes.

If one of these two technical amendments is not included in the Technical Corrections Act the foreign shareholders of RICs qualifying as 80-20 Corporations likely will withdraw all of their funds from these RICs and reinvest in mutual funds organized outside of the United States. This shift in investment would benefit the foreign investment advisory community to the detriment of their United States counterparts which service RICs qualifying as 80-20 Corporations.

The first proposed technical amendment would exempt RICs which qualified as 80-20 Corporations under prior law from the new rules contained in Section 1214 of the Act solely for purposes of the withholding tax imposed on dividends paid by United States corporations to foreign shareholders. This amendment would have the effect of permitting these RICs to continue to pay dividends to their foreign shareholders without the imposition of any United States withholding tax.

The alternative proposed technical amendment would have the effect of permitting RICs qualifying as 80-20 Corporations under prior law to permanently rely on the special transitional rule contained in Section 1214 of the Act by making the new "active foreign business income" requirement referred to above permanently inapplicable to RICs. While not as advantageous to RICs as the first alternative, this amendment would allow some RICs qualifying as 80-20 Corporations under prior law to continue in business.

The alternative technical amendments proposed herein should not result in any revenue loss to the United States Treasury. After the termination of the special transitional rule noted above, Section 1214 of the Act will not raise any revenue from RICs qualifying as 80-20 Corporations since, as noted above, these RICs simply will move offshore or terminate their existence if the provision is not changed in the manner suggested herein. Conversely, the amendments proposed herein would not cause a loss in revenue because they merely maintain the status quo existing prior to the Act (i.e., no United States withholding tax would be imposed on dividends paid to foreign shareholders by RICs qualifying as 80-20 Corporations).

Discussion of Alleged "Tax Treaty Shopping"

In considering these alternative technical amendments, we understand that the Treasury Department has expressed some concern that these amendments may have the effect of encouraging certain foreign shareholders of the RICs involved to invest in these funds for the purpose of "tax treaty shopping". Specifically, we understand that the Treasury Department believes that certain foreign shareholders invest in RICs qualifying as 80-20 Corporations for the primary purpose of avoiding the imposition of a withholding tax by the foreign countries in which the issuers of the debt instruments acquired by the RICs are resident. The Treasury Department's concern apparently is premised on the assumptions that (1) the foreign shareholders of these RICs would be subject to such foreign withholding taxes if they were to invest in those debt instruments directly, and (2) these foreign shareholders can avoid the imposition of such foreign withholding taxes by investing in a RIC qualifying as an 80-20 Corporation by reason of the interest withholding exemptions set forth in the provisions of income tax treaties between the United States and these foreign countries.

We do not believe that the "tax treaty shopping" abuse raised by the Treasury Department exists. Contrary to the Treasury Department's first assumption, most of the foreign countries in which the issuers of the debt obligations held by these RICs are resident do not impose any withholding tax on interest payable on the bank deposits and certain other debt obligations of entities resident in their country. Such foreign withholding tax exemptions are similar to the statutory exemptions from United States withholding taxes for interest payable to foreigners with respect to bank deposits and for "portfolio interest". See sections 871(i), 871(h) and 881(i) of the Internal Revenue Code. Therefore, the foreign shareholders of RICs qualifying as 80-20 Corporations under prior law could invest directly in many of the foreign debt instruments acquired by these RICs without themselves being subject to any foreign withholding taxes. In these cases, these foreign shareholders are not in any way taking advantage of the provisions of any income tax treaty to which the United States is a party.

Further, foreign individuals and entities have generally invested in the RICs that qualified as 80-20 Corporations for the purpose of short-term cash management. For example, at any one time, the investments of these RICs consist of debt instruments issued by issuers resident in a number of different countries and the average maturity of these debt instruments generally is less than 45 days. Since the composition of the investment portfolio of these RICs constantly is changing based upon the market conditions existing in the various foreign countries involved, the foreign shareholders of these RICs do not know the precise nature of the RIC's investments at any time and cannot properly be regarded as using the RICs primarily as a "tax treaty shopping" vehicle. Shareholders are not informed prospectively of the RIC's investments and, therefore, would not be able at the time of the investment to determine the identity of the foreign country in which the issuers of the debt instruments owned by the RIC are resident.

Nevertheless, the two alternative technical amendments to Section 1214 of the Act that have been proposed by Congressman Matsui address the Treasury Department's concern. This is accomplished by denying the applicability of these amendments to any RIC with respect to any taxable year in which more than 50 percent of the total value of the RIC's assets for the year are invested in assets the income from which is exempt from foreign withholding taxes solely by reason of the provisions of an income tax treaty between a foreign country and the United States. Therefore, any RIC which fails this 50 percent asset test would be deemed to be party to "tax treaty shopping" by its foreign shareholders and the dividends paid by such a RIC to these foreign shareholders would be subject to a United States withholding tax under the Act.

Based upon the above, we therefore respectfully request that one of the two alternative technical amendments which have been proposed by Congressman Matsui to Section 1214 of the Act be included in the Technical Corrections Act. I you have any questions concerning the proposed technical amendments, please contact Paul Clark at (202) 466-3960 or Peter Pront at (212) 412-4100.

Seward & Kissel

Shawmut

July 17, 1987

Laura Wilcox
Hearing Administrator
Committee on Senate Finance
Room SD 205
U. S. Senate
Washington, DC 20510

RE: S1350 Technical Corrections Bill of 1987

Dear Ms. Wilcox:

On behalf of Shawmut Corporation's Central Tax Unit, of which I am employed by, and the Massachusetts Bankers Association, of which I am a member, please read the following:

First off, to make retroactive the switching of Common Trust Funds to a calendar year end for tax years beginning after December 31, 1986 would truly be a hardship for banks with all that is going on this year. The changing of fiscal year end trusts and the paying of federal estimates, to name a few, are enough in themselves for one year. To add another piece to the puzzle this year would only increase the compliance nightmare required by Fiduciaries.

Secondly, I fully support the ABA in urging that a November 30 fiscal year end be permitted for the Common Trust Funds. But, only if it were for years beginning after December 31, 1987.

The most logical plan in my opinion, would be for the Common Trust Funds to be permitted to be on an October 31 fiscal year end. In any case, allowing the Common Trust Funds to file on a fiscal year end would most certainly cause less of a compliance nightmare.

My final thought is this; that legislation not be passed making it retroactive for Common Trust Funds to be filed on calendar year ends for years beginning after December 31, 1986, but rather legislation be passed permitting Common Trust Funds to remain on fiscal year ends, say either October 31 or November 30, beginning with tax years after December 31, 1987.

I look forward to hearing any comments or questions you might have and can be reached at (617) 793-4161.

Respectfully,

Robert G. Ripley, Jr.
Vice President

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June 23, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Re: S 1350, H.R. 2636

Dear Ms. Wilcox:

Please note that Title I, Section 113(c)(12)(A) of S 1350 and H.R. 2636 should be changed by substituting "1954 Code" for "1986 Code" after the words "Subparagraph (N) of section 103(b)(6) of the ...." This reference is found on page 395, line 11 of H.R. 2636.

Thank you.

Very truly yours,

Stephen B. Lyons

cc: Ms. Mary McAuliffe

SBL/cmo

Squire, Sanders & Dempsey

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July 9, 1987

HAND DELIVERED

Ms. Laura Wilcox
Hearing Administrator, U.S. Senate
Committee on Finance
Room SD205
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments on S.1350, Technical Corrections Act of 1987, Effective 1986 TRA Retroactive Repeal of Investment Tax Credit on Horizon Air

Dear Ms. Wilcox:

Request is hereby made on behalf of Horizon Air Industries, Inc. d/b/a Horizon Air as well as its parent corporation, Alaska Air Group, Inc. for an opportunity to present testimony before the Subcommittee on Taxation and Debt Management chaired by The Honorable Max S. Baucus. We understand that hearings are now scheduled for July 22nd at 9:30 A.M. in Room SD215 of the Dirksen Senate Office Building.

We would appreciate being notified whether you are agreeable to receiving our testimony which would be very brief and which will address the unusual and totally unforeseen problem now facing Horizon Air, a large commuter air carrier based in Seattle, Washington, because of the retroactive repeal of the investment tax credit.

Very truly yours,

Marshall S. Sinick

Marshall S. Sinick

MSS:mc
Enclosure

cc: Honorable Charles A. Vanik
William Diefenderfer, Esq.

Squire, Sanders & Dempsey

Re: Comments on the Technical Corrections Act of 1987, (S. 1350); Effect of the Tax Reform Act of 1986 on the sale of stock to ESOPS.

Dear Ms. Wilcox:

This letter describes a technical problem created by H. R. 1311 and S. 591, both of which may be incorporated into the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350).

Our client, Frances G. Shoolroy, is the Personal Representative of the Estate of Ross K. Shoolroy, who died on June 27, 1987. As Personal Representative, Mrs. Shoolroy is the legal owner of a large number of shares of Ashland Oil Company, Inc. to which the provisions of Section 2057 of the Internal Revenue Code of 1986 would apply. The estate tax deduction provided by Section 2057 with respect to sales of employer securities to an ESOP would generate a considerable estate tax deduction for Mr. Shoolroy's estate. The enactment of H.R. 1311 and/or S. 591 would, however, create totally unforeseen problems for our client. As mentioned previously, these Bills may be incorporated into the Technical Corrections Act of 1987.

Mrs. Shoolroy, as Personal Representative, has been placed in an untenable position as a result of the conflict between current law and the pending legislation. As a fiduciary, Mrs. Shoolroy is under an obligation to minimize federal estate taxes, even though under the decedent's estate plan she will not directly benefit from the estate tax savings. Under current law, the federal estate tax can be reduced by selling the securities to an ESOP at a discount, and claiming the deduction allowed by Section 2057. If the estate's deduction is eliminated by the enactment of H.R. 1311 and/or S. 591, however, Mrs. Shoolroy may be liable to the residuary beneficiaries under the decedent's will for breach of fiduciary duty in selling the securities at a discount. If Mrs. Shoolroy does not sell the securities immediately, however, and thereby loses the benefit of any effective date relief which might be provided under H.R. 1311 and/or S. 591, she may be held accountable for loss of the estate tax deduction.

Finally, in this particular situation, there will be an ancillary benefit to allowing the estate to claim the deduction provided by Section 2057. The ESOP involved will be able to purchase the securities at a discount, thereby providing greater benefits to the employees it covers.

In summary, then, the conflict between current law and the provisions of H.R. 1311 and S. 591 not only place the estate's Personal Representative in an untenable position, but also adversely affect both the estate and the ESOP.

Your consideration of these comments will be greatly appreciated.

Sincerely,

Neil R. Chrystal
JJH

Neil R.Chrystal

Summary Of A Written Submission For The Record
By

Frances Shoolroy, Executrix of the Estate of Ross K. Shoolroy

Relating To

Sales Of Stock By Estates To ESOPs
In The
Technical Corrections Act of 1987
(S. 1350)

July 14, 1987

This comment relates to the enactment of H.R. 1311 and/or S. 591, which may be incorporated into the Technical Corrections Act of 1987 (S. 1350). The Tax Reform Act of 1986 provided an estate tax deduction for sales of employer securities to an ESOP. This deduction is available to the Estate of Ross K. Shoolroy. Because of the deduction the Estate would benefit from a sale to an ESOP even though the per-share sales price would represent a significant discount from the market value of the stock. This deduction will not be available to this Estate if S. 591 and/or H.R. 1311 is enacted. The conflict between current law and the provisions of H.R. 1311 and S. 591 now make it impossible for the Executrix of this Estate to meet her fiduciary obligations to the Estate's residuary beneficiaries to conserve the value of the Estate's publicly-traded stock while at the same time acting reasonably to minimize taxes. Further, if S. 59 and/or H.R. 1311 are enacted the ESOP involved will lose the opportunity to purchase a substantial block of employer securities at a significant discount, to the detriment of the ESOP's participants.

Comment Regarding Section 114(g)(2)(D) of the Technical Corrections Act of 1987 -- Effective Date of the Revised Generation-Skipping Transfer Tax

Summary: Section 114(g)(2)(D) of the Technical Corrections Act of 1987 modifies Section 1433(b)(2)(C)(i) of the Tax Reform Act of 1986, the mental disability exemption, in a way that produces an inequitable and arbitrary result for persons who were adjudged incompetent in the period between September 25, 1985 and October 22, 1986 but who failed to die prior to January 1, 1987. This proposed amendment more rationally accomplishes the purposes of Section 114(g)(2)(D) of the Technical Corrections Act of 1987.

Text of Proposed Amendment: In accordance with the foregoing, Section 114(g)(2)(D) of the Technical Corrections Act of 1987 is proposed to be amended as follows:

Sec. 114. Amendments Related to Title XIV of the Reform Act.

*   *   *

(g) Amendments related to Section 1433 of the Reform Act.--

*   *   *

(2) Paragraph (2) of Section 1433(b) of the Reform Act is amended --

*   *   *

(D) by ~~striking out "on the date of the enactment of this Act" and inserting in lieu thereof "September 25, 1985".~~ <u>inserting in subparagraph (C) "under a will or revocable trust executed before September 25, 1985" after "any generation-skipping transfer".</u>

FOR FURTHER INFORMATION CONTACT: Sherwin P. Simmons, Karen E. Lewis, or Charles T. Plambeck; Trenam, Simmons, Kemker, Scharf, Barkin, Frye & O'Neill; 2600 First Florida Tower, Post Office Box 1102; Tampa, Florida 33601-1102; (813) 223-7474.

SUPPLEMENTARY INFORMATION: Prior to the Tax Reform Act of 1986 (hereafter "Reform Act"), Chapter 13 of the Internal Revenue Code of 1954, the generation-skipping transfer tax provisions (Sections 2601-2622) generally applied to any generation-skipping transfer made after June 11, 1976 (hereafter "1976 GST Tax").

Section 1433(c) of the Reform Act repealed the 1976 GST Tax, retroactive to June 11, 1976. All amounts collected under the 1976 GST Tax were required to be credited or refunded (with interest) as an overpayment. Reform Act, Section 1433(c)(1).

Section 1431 of the Reform Act creates a new tax on generation-skipping transfers, the provisions of which appear in Chapter 13 of the Internal Revenue Code of 1986 (Section 2601 - 2663) (hereafter "1986 GST Tax").

Section 1433(a) of the Reform Act provides that the 1986 GST Tax applies to any generation-skipping transfer made after October 22, 1986.

However, Section 1433(b)(2) of the Reform Act excepts from the 1986 GST Tax certain generation-skipping transfers. According to the Conference Report, the delays in effective dates were adopted to permit a reasonable period for individuals to re-execute their wills to conform to the 1986 GST Tax, or to eliminate a hardship on individuals prevented by mental disability from re-executing their wills.

Section 1433(b)(2)(C)(i) of the Reform Act excepts from the 1986 GST Tax any generation-skipping transfer under a trust to the extent that such trust consists of property included in the gross estate of a decedent (other than property transferred by the decedent during his life after October 22, 1986), or reinvestments thereof, but only if such decedent was, on October 22, 1986, under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death.

Section 114(g)(2)(D) of the Technical Corrections Act of 1987 proposes to modify Section 1433(b)(2) by striking out "on the date of the enactment of this Act" and inserting in lieu thereof "September 25, 1985". This has the effect of requiring that the person be incompetent prior to September 25, 1985 rather than prior to October 22, 1986.

The description of the Technical Corrections Act of 1987 published by the Staff of the Joint Committee offers no explanation for the change in date. It appears, however, that the modification was intended to make Section 1433(b)(2) symmetrical with Section 1433(b)(1), which subjects inter vivos transfers after September 25, 1985 to the 1986 GST Tax.

The transitional rule of Section 1433(b)(1) is rationally drawn so that transfers made in contemplation of the 1986 GST Tax do not escape taxation. However, it strains reason to predicate the transitional rule of Section 1433(b)(2) on the possibility that adjudication of incompetency will be undertaken to escape taxation.

The amendment proposed by this comment avoids the problems created when an effective date is measured by a wholly fortuitous event (the date of adjudication of incompetency). The amendment also is consonant with the transition rules of Section 1433(b)(2)(A) and Section 1433(b)(2)(B), eliminating inconsistency of treatment. The amendment seeks to achieve the purposes of existing Section 114(g)(2)(D) of the Technical Corrections Act of 1987 without the existing arbitrariness.

SMITHKLINE BECKMAN CORPORATION COMMENTS ON
S.1350, THE TECHNICAL CORRECTIONS ACT OF 1987

SmithKline Beckman Corporation respectfully submits to the Senate Finance Committee the following comments regarding matters for inclusion in S.1350, the Technical Corrections Act of 1987. The comments relate to an unintended inequity in the tax law that results in a significant double tax to SmithKline Beckman Corporation.

<u>Legislative Background</u>

The inequity described below originated as an oversight in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), as a result of amendments to section 936, which creates double taxation for SmithKline Beckman. The inequity was compounded by the Tax Reform Act of 1986 (the '86 Act) as a result of amendments to sections 482 and 936(h) which require income with respect to a transfer or license of intangible property to be commensurate with the income attributable to the intangible (the super royalty).

<u>--Section 936(h) Cost Sharing</u>

Section 936(h), enacted as part of TEFRA, deals with the tax treatment of intangible property income of possessions corporations and their shareholders. Under the TEFRA rules, a 936 company that elects cost sharing is required to make a cost sharing payment for use of intangibles developed or otherwise made available to it by its affiliates. The '86 Act required that the amount of the cost sharing payment be the greater of 110 percent of the cost sharing payment as required under TEFRA, or the payment which would be required if the electing corporation were a foreign corporation, i.e,. a royalty that is commensurate with the income attributable to the intangible. The cost sharing payment must be made to the electing corporation's U.S. affiliate, under the current interpretation of the section 936(h) cost sharing provisions, and is taxable in the U.S., even if the intangibles are discovered and owned by a foreign affiliate. No reduction is permitted for the royalties paid to <u>affiliated</u> foreign corporations. However, existing tax law (Sec. 936(h)(5)(C)(i)(I)) would permit a reduction in the cost sharing payment required to be made to the U.S. affiliate if the royalty were paid to an <u>unrelated</u> foreign company for use of intangible property discovered or owned by the foreign company.

<u>--Section 482 Royalty Payments</u>

In the subject circumstances, intangibles were created by a U.K. affiliate which licensed the intangibles to a possessions corporation. Under that agreement, the possessions corporation pays an arm's length royalty based on its sales of products manufactured under the licensed intangibles. Such a royalty is subject to review and approval by U.K. Inland Revenue, and is subject to being increased, on examination, in the same manner and for the same reasons that royalty payments by 936 corporations to their U.S. parent companies have been increased periodically by the Internal Revenue Service on examination. The royalty must be arm's length under standards similar to section 482.

<u>Double Taxation</u>

SmithKline Beckman's problem arises because the royalty which its possessions corporation pays to its U.K. affiliate is not deductible in computing its cost sharing payment under section 936(h). Thus, in effect, a double payment is made by the 936 company for the use of the same intangibles, with the royalty taxed by the foreign country and the cost sharing payment taxed by the U.S. In addition, under the '86 Act, the double tax result under TEFRA is further aggravated by the possibility of a double super royalty. Combined, the two superroyalty payments with respect to the same intangibles could eliminate all of the profits of an electing (936) corporation under the cost sharing method.

<u>The Super Royalty</u>

The super royalty provisions generally provide that a related party royalty under section 482 as well as the cost sharing payment under section 936(h) must be commensurate with the income stream attributable to the transferred intangible. It should also be noted that the super royalty may also be used by foreign taxing authorities to determine an appropriate arm's length royalty from their perspective. For example, where the intangibles are discovered in the U.K., the U.K. Inland Revenue surely would feel that the U.K. taxpayer was entitled to the super royalty amount. Where both these payments must be made with regard to the same intangible property, the double application of the super royalty will result. This problem will not only affect SmithKline Beckman, but also other U.S. companies having products invented by foreign subsidiaries.

<u>--Example of Double Taxation and Double Super Royalty</u>

The following example is illustrative of the combined effect of the double tax and the double super royalty:

U.K. Co., an affiliate of U.S. Co., discovers product "A" through its own R&D efforts in the U.K. and registers a patent for product "A" around the world. U.K. Co. licenses 936 Co., a subsidiary of U.S. Co. to manufacture and sell product "A" and charges 936 Co. an arm's length royalty for use of its patent and other intangibles. 936 Co. has elected the cost sharing method under section 936 (h).

The unintended result under TEFRA which will be compounded by the '86 Act is as follows:

> Although product "A" was not discovered in the U.S., sales of product "A" manufactured in the possession will increase the cost sharing payment required to be made by 936 Co. to U.S. Co. each year, which payment is subject to U.S. income tax currently. Under the '86 Act the cost sharing payment will come under the super royalty provisions. The arm's length royalty paid by 936 Co. to U.K. Co. is also subject to U.K. income tax currently.
>
> The cost sharing payment made by 936 Co. covering the use of the same product "A" intangibles cannot be reduced by the royalty paid to U.K. Co. under the existing TEFRA rules Thus, the affiliated group has made payments for the use of the same intangibles to the U.K. and the U.S., both of which payments are taxed currently in the U.K. and the U.S.--a double tax.
>
> The '86 Act and the new super royalty rules apply both to the cost sharing payment made by 936 Co. to U.S. Co. and could also apply under the international application of the super royalty provisions to the royalty paid by 936 Co. to U.K. Co. Thus, a double super royalty.

<u>Technical Correction</u>

To be fully responsive to the double taxation problem, the technical correction must refer back to the effective date of TEFRA. The unintended double taxation problem as well as the double super royalty problem can be addressed through a technical correction that is simple to make. The correction would, in effect, recognize the arm's length royalty payment, as determined under section 482, to the foreign affiliate as a payment of cost sharing and permit that portion of the cost sharing payment to be made to the appropriate foreign affiliate. Specifically, this change would correct an unintended interpretation of section 936(h)(5)(C)(i)(IV)(a) to the effect that where there is any domestic member of the affiliated group to which a cost sharing payment can be made, then no payment can be made to a foreign member of the affiliated group. We believe that Congress did not intend a double tax result and, therefore, obviously intended a broader interpretation be given to the term "appropriate" in that subparagraph of the Code. Clearly, the tax impact on the electing corporation and its affiliates should be the same whether the royalty is paid to a related or an unrelated foreign company. We believe this to be an unintended oversight, when applied to the facts of SmithKline Beckman's situation, which results in the aforementioned double taxation.

--Suggested Language

The technical correction we are proposing can be effected by adding the following sentence at the end of the subparagraph (a) referred to above:

> Notwithstanding the preceding sentence, in the case of a payment by the electing corporation to a related party for a license from such related party, to the extent that such payment does not exceed an arm's length consideration under the principles of section 482, the amount paid as consideration shall be deemed not to be a royalty or other consideration for such license but shall be treated as a payment of cost sharing required under paragraph (IV) and shall reduce the amount otherwise payable to other members of the affiliated group.

--Limited Application of Technical Correction

The proposed technical correction would not be subject to abuse since (1) it would only apply where a foreign affiliate has in fact transferred or licensed intangible property to an electing (936) corporation and (2) it is limited by the arm's length standard of section 482, i.e., to situations where the royalty payment does not exceed the payment that unrelated parties dealing at arm's length would agree upon. Thus, the Internal Revenue Service would have a standard in its own regulations by which to measure the appropriateness of the royalty and, in the case of a country with which the U.S. has concluded an income tax treaty, an agreement could be reached with the foreign government's competent authority if a dispute arises. Additionally, the provision could be limited to application where the foreign affiliate is subject to a substantial income tax or only to countries which have income tax treaties with the U.S., or both.

--Revenue Effect

The proposed technical correction is believed to be revenue neutral because the double taxation result was never contemplated or intended by Congress and, therefore, no revenue could have attached to it.

SOUTHERN IDAHO CORPORATION
OF SEVENTH - DAY ADVENTISTS

CHARITABLE TRUST SERVICES
7777 FAIRVIEW, P.O. BOX 4878, BOISE, IDAHO 83704 • 208/375-7524

July 6, 1987

Laura Wilcox
U.S. Senate Committee on Finance
SD 205
Washington, D.C. 20510

Dear Ms. Wilcox:

As a "Charitable Institution" we sincerely hope that you will do all in your sphere of influence to amend the Technical Corrections Act of 1987 (H.R.2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

People use "Gift Annuities" to help charitable organizations not merely as an insurance policy.

I trust that this will have your immediate attention and that you will not allow the law to legally dry up the help that many charitable institutions are now receiving through this "Gift Annuity" program.

Sincerely yours,

Leon Cornforth
Director of Trust Services
IDAHO CONFERENCE OF SDA
LC/bc

GINSBERG & FORMAN
ATTORNEYS AT LAW
820 HARTFORD BUILDING
DALLAS, TEXAS 75201

R. M. GINSBERG
DONALD J. FORMAN
HOWARD A. WEINBERGER
DAVID G. ADLER
STANLEY C. SIMON

AREA CODE 214
744-0044

June 19, 1987

Ms. Laura Wilcox
Hearing Administrator
Committee on Finance
Room SD-205
United States Senate
Washington, D.C. 20510

Re: Technical Corrections Act of 1987 (S. 1350 and H.R. 2630)

Dear Ms. Wilcox:

Sec. 111(m)(11) of the bill would amend section 4979(f)(2) of the 1986 Code to provide two rules on the taxation of excess contributions and excess aggregate contributions distributed within 2½ months after the end of the plan year. If the amount distributed were less than $100, it would be taxed when distributed; if $100 or more, it would be taxed in the prior year. The de minimus rule is intended to simplify reporting for recipients of small amounts.

If the plan is required to file an information return with the Internal Revenue Service which merely shows the amounts paid and the dates of payment, this provision would not create too many problems for the plan. A calendar year plan, for example, could include with each 1988 check a printed statement explaining that, if the amount was less than $100, it was taxable in 1988; if $100 or more, in 1987. On the other hand, if the plan is required to file information returns which show the year of taxability, there will be major problems for large plans.

The Southland Corporation Employees' Savings and Profit Sharing Plan is working as fast as it can to program the computer to make the required distributions before March 15, 1988. If it has to put additional steps into the program to show different dates of taxability in information returns, it may not be able to get the programming done in time.

I suggest that either the statute of the committee reports make it clear that the paying plan does not have to inform the payee or the IRS specifically in which year the payment is taxable. I also have alternative suggestion, which would greatly simplify plan administration and still achieve rough justice.

Instead of requiring payment within 2½ months after the end of the plan year and taxing amounts of $100 or more in the prior year, permit distribution not later than the end of the following plan year and require the distributee to include 110% of the amount distributed in income. If you think 10% is too rough, you could use the average underpayment rate for the calendar year as determined under section 6621(a)(2) of the 1986 Code. Both the payee and the Treasury would be in about the same place as they would have been under present law; and life would be easier for plan administrators, who would not have to rush, for payees, who would not have to file amended returns if they had filed before March 15, and for the IRS, which would not have to process amended returns.

Sec. 111A(g)(5) would add a new paragraph (5) to Sec. 4980A(d) of the 1986 Code. This new paragraph would permit a spouse, if the beneficiary of all of the interests in the deceased spouse's retirement plans, to elect (1) not to have the special estate-level tax apply and (2) to have any distributions received aggregated with the spouse's own distributions and taxed under the general rule. This is a good rule, but it needs one small modification to simplify estate planning.

Many individuals, fearing their spouses' improvidence, make their retirement benefits payable to trusts for the benefit of the spouses. This was recognized and accommodated in Sec. 401(a)(9)(B)(iii)(I).

The rule in Sec. 4980A(d)(5) should be extended so that the election could be made if the spouse and/or trusts for the benefit of the spouse are beneficiaries of all interests in the retirement plans. If you wanted, the trusts could be limited to those in which a spouse was entitled to all the income. See paragraphs (5) and (7) of Sec. 2056(b).

Sincerely yours,

Stanley C. Simon

SCS/trf

cc: Mary McAuliffe
John H. Rodgers

SOUTHWESTERN BAPTIST
THEOLOGICAL SEMINARY
P.O. Box 22000/Fort Worth, Texas 76:22
(817) 923-1921

James Holcomb
Director of Development

July 16, 1987

The Honorable Lloyd Bentsen
703 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Bentsen,

Please amend the Technical Corrections Act of 1987 (S.1350) to clarify that charitable gift annuities issued by IRC Sec. 501 (c) (3) organizations are not "commercial-type insurance" under IRC Sec. 501 (m). This is very important to the financial security of Southwestern Baptist Theological Seminary and other charitable organizations such as ours.

Gift annuities are used by donors to Southwestern Seminary because they want to make a gift to help us train ministers. Gift annuities don't compete with commercial annuities and are not "commercial-type insurance."

If this law is not clarified, gift annuities will no longer be a viable option for donors to Southwestern Seminary and we will lose approximately 10 percent of the gifts we raise each year. Gift annuities have been used by charitable organizations such as Southwestern Seminary for over 100 years. For small donors, such as the ones who contribute to Southwestern Seminary, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501 (m).

Let me strongly urge that you amend the law and preserve this very important giving vehicle for our donors. Please let me know if you have any questions or if I can supply you with additional information.

Sincerely yours,

James Holcomb

James Holcomb

JH:jj

XC: Jim Gould

Statement of William T. Brack

On Behalf of

Southwestern Bell Corporation

On

S.1350, The Technical Corrections Act of 1987

The transition rule in the Tax Reform Act of 1986 ("TRA") for elections to treat stock acquisitions as asset acquisitions under Internal Revenue Code ("IRC") section 338, left open an area of uncertainty regarding binding contracts entered into prior to August 1, 1986 which are subsequently modified to account for pre-existing contract rights or actions by courts or administrative agencies. Given the potential punitive tax liability which could accrue from a section 338 election if the Internal Revenue Service ("I.R.S.") takes a contrary position, more certainty is necessary to prevent the current rules from being a trap.

I. The Problem

Prior to the changes enacted in TRA section 631, IRC section 338 provided that a corporation that purchased 80% or more of the stock of another corporation (target) could make an election which caused the target to be treated as if it had sold its assets under section 337 and purchased those assets for the cost of the stock. Section 337, at that time, provided that, with limited exceptions, there would be no recognized gain or loss on the sale. TRA section 631 eliminated both the reference in section 338 to section 337 and the provision in section 337 that there would be no recognition of gain or loss.

The impact of this change can be illustrated by the following example.

Example

"A" corporation has a basis of $100 in depreciable assets with a fair market value of $1,000 and a zero basis in non-depreciable assets with a fair market value of $500. "B" corporation purchases "A" corporation stock from A's shareholders for $1500. "B" corporation makes a section 338 election. Suppose the tax liability from investment tax credit ("ITC") and depreciation recapture is $50. The impact under the old rules and the new is as follows.

Old Rules

"A" is treated as having sold its assets to new "A" for $1500. "A" has a basis of $1000 in depreciable assets and $500 in non-depreciable assets. "A" recognizes no gain as a result of the step-up in basis. "A" has an additional $900 which it can depreciate. These tax benefits would have a present value (depending on depreciation rates on the assets) of approximately $175, less the $50 recapture for a net present value of $125.

New Rules

"A" is still treated as having sold its assets to new "A" and still has an additional $900 to depreciate with a present value of approximately $125. Under the new rules, however, the gain is taxable. "A" has a gain of $1400 which, at a 40% rate of tax, is $560 of tax, plus ITC recapture. "A" owes more than $560 of tax and has depreciation deductions with a present value of only about $125. "A" loses more than $435.

With other transitional rules in the Tax Reform Act, the issue is usually whether the taxpayer is entitled to receive a deduction or credit. If it is later determined that the taxpayer did not qualify under the transition rule then he owes the amount of the tax applicable to the deduction or credit plus interest. With the transition rules for the Section 338 election, however, the taxpayer faces a severe penalty if it is determined that it did not qualify for the transitional rule. Based on the above examples illustrating the impact of the application of the old and new rules, a proper Section 338 election followed by a challenge by the I.R.S. that the contract was not binding would penalize the taxpayer three or more times for being wrong.

Using the above example as a point of reference to the problem with the TRA transition rule, the issue seems to be whether taxpayer is entitled under TRA section 633 to receive tax benefits worth $125. By not repealing IRC section 338, however, but by merely changing the tax treatment of the election, the election becomes a trap for any corporation that incorrectly believes that it is qualified under the transitional rule, with a massive penalty for being wrong.

As a result of the enormous exposure to potential tax liability, a corporation must be certain that it qualifies under the transitional rule in TRA section 633. Unfortunately, the drafting of the rule is susceptible to various interpretations, and does not provide the certainty needed to allow a section 338 election to be made.

An examination of the language of TRA section 633(c)(1)(D) does not immediately reveal the problem, however. This section (c)(1)(D) reads:

> "(1) IN GENERAL -- The amendments made by this subtitle shall not apply to --
>
> (D) any transaction described in Section 338 of the Internal Revenue Code of 1986 with

> respect to any target corporation if a qualified stock purchase of such target corporation is made on or after August 1, 1986, pursuant to a written binding contract in effect before such date and the acquisition date (within the meaning of Section 338) is before January 1, 1988."

The problem with the transition rule, which does not appear on its face, originates in the case law and regulations regarding other transitional rules involving binding contract provisions. The problem is that the Internal Revenue Service frequently contests the binding nature of the contract based upon contingencies in the contract or amendments made after the transition date. For example, if a portion of the property of the acquired corporation is not acquired by the acquiring corporation because of a right of first refusal or if such portion of the property cannot be acquired because it is prohibited by an agency or court, the I.R.S. could take the position that the contract on the stock was acquired was not binding.

This problem is considerably worse with regard to corporate acquisitions than with the purchase of equipment. Corporate purchase contracts must contain numerous conditions and contingencies. In addition, most major contracts for the acquisition of other corporations are amended as problems appear up through the closing date for pre-existing contractual obligations or because the Federal Trade Commission or other agency prohibits such acquisition.

The question left open by current TRA section 633 is: are such contracts still binding as of August 1, 1986, even with such conditions, contingencies and amendments? They almost certainly are, because the parties are mutually obligated to fulfill the contract and must act in good faith to fulfill the conditions and satisfy the contingencies. The cost of fulfilling that commitment and having the I.R.S. contend that the contract was not binding, however, may be three or more times the potential benefit. Few purchasing corporations are able to take such a risk.

The legislative history of TRA section 633(c)(1)(D) does provide some assistance by stating that provisions in a contract regarding normal commercial due diligence do not make a contract non-binding and that the terms of the acquisition may vary pursuant to such provisions. This language is, unfortunately, extremely vague. What constitutes "normal" due diligence? Does "vary" mean that the contingency activates a specific formula in the contract, or does it also cover ad hoc amendments adopted after the occurrence of the contingency?

To summarize, TRA section 633 provides a transitional rule intended to cover certain contracts. Nevertheless, in most instances, taxpayers will not be able to use the transition rule because, while the law strongly favors them, the liability in the event the taxpayers do not qualify for the rule will be catastrophic.

An additional problem is faced by some companies that intended to rely on the transition rule and that find the potential liability too high to make a section 338 election. For the purchase of tiered corporations, a section 338 election can increase the tax basis of assets among the tiers. With lower bases throughout the tiers (when the section 338 is not valid under the transition rule), a taxpayer faces multiple levels of taxation and difficulties in reorganizing or selling pieces of the acquired corporations. Extremely complicated and expensive tax planning and requests for private letter rulings will be needed for what would have been routine sales or reorganizations had the section 338 election been available.

II. Proposed Correction

The solution to this drafting problem is to append to TRA section 633(c)(1)(D), the following:

> "Modifications to such a written binding contract made after August 1, 1986 will not cause such a contract to be deemed non-binding so long as these modifications do not increase the amount of property subject to this transitional rule."

We appreciate your addressing this issue. If you have any questions concerning our description of the problem or our proposed solution, I encourage you to contact me (William T. Brack) at 659-0702.

Southwestern University
AT GEORGETOWN, TEXAS

July 7, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance
S. D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I am writing to express opposition to a proposed provision of The Technical Corrections Act of 1987 which would eliminate the charitable deduction in computing computing the generation-skipping transfer tax on charitable lead trusts created after June 10, 1987.

This proposed "technical correction" would be a substantive change of the current law and it would have the effect of a dramatic increase on the taxation of remainder interests at the end of the term of charitable lead trusts. The effect would be to discourage this important source of gift revenue for countless charities.

Sincerely,

Rick Eason

Richard B. Eason
Vice President for Development

RBE:jr

Georgetown, Texas 78626
512-863-6511

Squire, Sanders & Dempsey

Statement on the Technical Corrections Act of 1987
(H.R. 2636 and S. 1350)

This statement describes a technical problem arising out of the generic transition rules of the Tax Reform Act of 1986 (the "Act") that would prevent the tax-exempt financing of certain pollution control facilities consisting of a cooling tower and related facilities at the Wm. H. Zimmer Generating Station (the "Zimmer Facilities"). The Zimmer Facilities are owned as tenants in common by The Cincinnati Gas & Electric Company, Columbus and Southern Ohio Electric Company and The Dayton Power and Light Company (the "Companies"), and the financeable cost is not currently expected to exceed $120 million. Squire, Sanders & Dempsey has been retained by the Companies, and this statement is being submitted on their behalf.

The problem involves the imposition of a pre-September 26, 1985 "inducement resolution or other comparable preliminary approval" requirement by Section 1312(a)(1)(B) of the Act to the tax-exempt financing of a facility that commenced construction before September 2, 1972 and that will be completed on or after September 26, 1985. This matter is not addressed in the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) as originally introduced. The following review of the existing Treasury Regulations containing the official action or inducement resolution requirement and the history of Section 1312 of the Act, as they affect the Zimmer Facilities, indicates why this correction is appropriate. Because the facts giving rise to this problem are rather unique, it is believed that there are no other similarly affected facilities. Therefore, the suggested correction would have a very limited impact.

Under Treas. Reg. §1.103-8(a)(5)(ii), copy attached, an exempt facility which commenced construction, reconstruction or acquisition before September 2, 1972, could satisfy certain applicable timing requirements if an appropriate official action or inducement resolution was adopted before the facility was placed in service. Under this rule, a facility where construction was commenced before September 2, 1972 and was completed on or after September 26, 1985 could satisfy Treas. Reg. §1.103-8(a)(5)(ii) if an appropriate official action or inducement resolution was adopted on or after September 26, 1985 but before the facility was placed in service.

On September 26, 1985 the Joint Committee on Taxation released a summary of tax reform options which included provisions to change certain rules applicable to tax-exempt financing of certain exempt facilities such as the Zimmer Facilities. These provisions had an effective date of December 31, 1985 with a transition rule exception allowing tax-exempt financing after that date for certain of these facilities where construction was commenced before September 26, 1985 and was completed on or after that date. The proposed transition rule contained an additional requirement that "[f]acilities would be defined as property for which bond financing was approved by a governmental unit . . . before September 26, 1985." H.R. 3838 as passed by the House of Representatives in December 1985 contained a transition rule exception (including a pre-September 26, 1985 inducement resolution requirement) similar to that set forth in the earlier Joint Committee statement. H.R. 3838 as passed by the Senate in June 1986 contained a parallel transition rule exception but substituted "March 1, 1986" for "September 26, 1985." The Conference Committee version of H.R. 3838 adopted the House transition rule on this point so that Section 1312(a)(1)(B) of the Act, as enacted into law in October 1986, contained a pre-September 26, 1985 inducement requirement. Significantly, there is no indication in the legislative history of the Act that Congress intended to repeal Treas. Reg. §1.103-8(a)(5)(ii) with the enactment of Section 1312(a)(1)(B) of the Act.

The construction of the Zimmer Facilities began before September 2, 1972 and they have not yet been placed in service. Thus, under the existing Treasury Regulations, the Zimmer Facilities could meet the timing requirements for tax-exempt financing as long as an "inducement resolution" was obtained before the placement in service date. On the other hand, the generic transition rule of Section 1312(a)(1)(B) of the Act requires adoption of an inducement resolution with respect to the Zimmer Facilities before September 26, 1985. The generating facility served by the Zimmer Facilities was originally planned as a nuclear power plant. The construction of the nuclear plant was not completed, and in 1984 the Companies decided to convert the partially constructed plant to a coal-fired facility. In November 1984 the Companies obtained an inducement resolution with respect to the yet-to-be constructed pollution control facilities for the coal-fired facility. However, in reliance on the pre-September 2, 1972 rule of Treas. Reg. §1.103-8(a)(5)(ii), the Zimmer Facilities were not expressly described in that inducement resolution. In response to the new requirement of Section 1312(a)(1)(B), an amended inducement resolution specifically referring to the Zimmer Facilities was obtained on November 7, 1985, and consequently the Zimmer Facilities have now clearly satisfied Treas. Reg. §1.103-8(a)(5)(ii). Moreover, the Zimmer Facilities would have satisfied the Senate transition rule based on a March 1, 1986 date but do not satisfy the transition rule of the Act based on a September 26, 1985 date.

The unfairness caused by Section 1312(a)(1)(B) of the Act in this case is due to the fact that the new inducement resolution rule was first made public on September 26, 1985, and as a result it became effective immediately, even though under then existing law no such requirement applied to the Zimmer Facilities. It is particularly inequitable to deny tax-exempt financing of the Zimmer Facilities where tax-exempt financing had been contemplated by the Companies well before September 26, 1985, but where an inducement resolution had not been obtained as of that date in reliance on the existing Treasury Regulations.

The foregoing circumstances involve a case where Congress should make a technical correction to the Act that would permit tax-exempt financing on a transition rule basis of a project, such as the Zimmer Facilities, where construction had commenced before September 2, 1972 and was still ongoing on September 26, 1985 and where an inducement resolution was obtained after September 26, 1985. An appropriate technical correction would be one that applied for purposes of Section 1312 of the Act the pre-September 2, 1972 rule of Treas. Reg. §1.103-8(a)(5)(ii). The following language, added to either Section 1312 or Section 1318 of the Act, would accomplish this purpose:

> In the case of a facility the construction, reconstruction or acquisition of which commenced before September 2, 1972, the requirement of subsection 1312(a)(1)(B) shall be satisfied if an inducement resolution or other comparable preliminary approval is adopted by an issuing authority (or by voter referendum) before the date the entire facility is or was first placed in service.

Because Section 1318 contains a number of special rules relating to effective dates and transition rules, it is probably more appropriate to make this correction in Section 1318.

Thank you for your consideration of this matter.

Respectfully submitted,

Jackson B. Browning, Jr.

Jackson B. Browning, Jr.

Comments to the Committee on Finance
U.S. Senate
on the Technical Corrections Bill of 1987, S.1350

Re: Proposed amendments to Section 2642 of the Internal Revenue Code of 1986 and enactment of new Section 2625.

Section 114(f)(4) of the proposed Technical Corrections Act of 1987, H.R. 2636 and S. 1350 (the "Bill"), as introduced in the House of Representatives on June 10, 1987, would amend Section 2642 of the Internal Revenue Code of 1986 ("I.R.C.") by eliminating certain provisions of the present generation skipping transfer tax law. Under the Tax Reform Act of 1986 (the "1986 Tax Act"), the present value of charitable interests created under an irrevocable charitable split-interest trust is deducted from the value of property transferred to such trust in determining the inclusion ratio for generation-skipping transfer tax purposes. I.R.C. §2642(a)(2)(B)(ii) and I.R.C. §2642(d)(2)(B)(i). The Bill would delete these provisions, so that the inclusion ratios of such trusts for generation skipping transfer tax purposes would be determined in total disregard of the actuarial value of the charitable interests in such trusts. The Bill would, instead, add a new Section 2625 to the Code, which is intended to provide for a reduction in the taxable amount by the amount of any charitable deduction which would be allowable under the estate or gift tax as of the time of the generation skipping transfer.

The proposed amendments to I.R.C. §2642 are not technical corrections, but rather are substantive changes which should be considered by Congress only, if at all, in the context of future tax reform legislation. Moreover, the suggested addition of proposed I.R.C. §2625 does not provide a workable alternative means of giving proper credit for charitable interests in the computation of the generation skipping transfer tax applicable to irrevocable charitable split-interest trusts.

Under the 1986 Tax Act, gifts or bequests which create irrevocable interests in both charities and grandchildren (or other natural persons treated as "skip persons") are treated equivalently under the generation skipping tax, whether such gifts are made outright (or in separate trusts), in a charitable lead trust, or in a charitable remainder trust. The application of the present I.R.C. §2642 results in identical inclusion ratios for all three forms of gift (assuming some allocation of the Generation Skipping Transfer Tax exemption to the grandchildren's interest) as long as the actuarial values of the charitable interest and the grandchildren's interest are the same for all three forms of gift. While the amount and timing of payment of the generation skipping tax will vary among the alternative forms of giving (because they involve, respectively, a direct skip, a taxable termination, and a series of taxable distributions), the use of the Treasury's actuarial tables to compute the present value of the noncharitable interests subject to generation-skipping tax results in equivalent tax treatment.

Under the proposed changes to §2642 and the proposed addition of new §2625, this equivalent treatment of actuarially equivalent gifts will be eliminated, setting up an arbitrary distinction between different forms of giving that have long been sanctioned by the Code for federal gift and estate tax purposes. The inclusion ratio for both charitable lead trusts and charitable remainder trusts will be the same as the inclusion ratio for a trust with no charitable interests; while the inclusion ratio for an outright gift (or a separate gift in trust) to grandchildren of an amount equal to the actuarial value of the grandchildren's interest in either type of charitable trust, will result in a lower inclusion ratio (because the value of the charitable gift is not part of the computation). Not only will the two split-interest trusts be subject to a higher inclusion ratio than the outright equivalent gift to grandchildren under the proposed change, but a further and arbitrary distinction will be created between charitable lead trusts and charitable remainder trusts.

Because the generation skipping transfer in a charitable lead trust will occur at the termination of the charitable interest, no adjustment in the amount subject to tax will be made under the proposed §2625 for the interest which has already passed to charity. (This adjustment is unnecessary under the 1986 Tax Act because the charitable interest will be taken into account in computing the inclusion ratio.) However, proposed §2625 should result in a reduction of the taxable amount with a charitable remainder trust because there remains a future charitable interest at the time the generation skipping transfers occur, that is, when distributions are made to grandchildren. Indeed, it is suggested by the example given in the "Description of the Technical Corrections Act of 1987" prepared by the Staff of the Joint Committee on Taxation (the "Staff Description") at page 262 that such an adjustment will be made (although there are technical problems with the application of proposed §2625 which will be discussed below). The result will be that less tax will be payable, even after taking into account the present value of payments when due, with a charitable remainder trust than with a charitable lead trust which has identical respective values for the charitable and the grandchildren's interests in the trust. Thus, as a result of the proposed changes, three different methods by which a donor may allocate gifts between charities and grandchildren, all of which have long been treated as equivalent under the established principles of valuation found in the estate and gift tax law, will be treated entirely differently under the generation skipping tax. There is no defensible reason for such unequal treatment of charitable giving techniques which have been well established as equivalent.

In addition, the technical application of the proposed §2625 is unclear. It is not clear that the example given in the Staff Description will be treated in the manner suggested. Because a charity has an "interest" in a charitable remainder trust, within the meaning of I.R.C. §2652(c)(1)(C), no taxable termination under I.R.C. §2612(a)(1)(A) occurs upon the expiration of the child's interest in the trust in the example given. Similarly a gift to a charitable remainder trust which establishes an annuity or unitrust interest for a grandchild, with remainder to a charity, will not constitute a "direct skip" within the meaning of I.R.C. §2612(c)(1) because the trust is not a "skip person" under I.R.C. §2613(a)(2). Accordingly, in both trusts, the generation skipping tax would be imposed on the "taxable distributions" to grandchildren. It is unclear how the reduction in the "taxable amount" called for by proposed §2625 would be computed for such "taxable distributions."

The legislative history of the 1986 Tax Act provides no support for changes to I.R.C. §2642 proposed in the Bill. The provisions of the 1986 Tax Act at issue were part of the original text of H.R. 3838 reported by the House Ways and Means Committee. The provisions were subjected to the various stages of Congressional review at that time and were enacted with no apparent question or concern about their intended meaning or application. The present provisions of the 1986 Tax Act establish fair and equivalent treatment of equivalent methods of making combined transfers to grandchildren and charities, and they are consistent with established valuation and taxation principles that have long been applied to such interests under estate and gift tax law. The amendments proposed in Section 114(f)(4) of the Bill would destroy that equivalence. In addition, the attempt to make wholly unanticipated and substantive changes in the generation skipping transfer tax enacted by the 1986 Tax Act through a Technical Corrections Act is inappropriate. We urge, therefore, that Section 114(f)(4) be deleted from the Bill.

Submitted by:

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Summary of Comments to the Committee on Finance, U.S. Senate

RE: Technical Corrections Bill of 1987, S. 1350, §114(f)(4)

The amendments to Section 2642 of the Internal Revenue Code of 1986 (the "Code") proposed in the Technical Corrections Act of 1987, H.R. 2636, S. 1350 (the "Bill") introduced in the U.S. House of Representatives on June 10, 1987, are substantive changes to the generation-skipping transfer tax which are not appropriate for consideration in a technical corrections bill.

Under Section 2642 of the Code, the present value of charitable interests in certain irrevocable trusts is deducted from the value of the property transferred at the time the transfer is made in determining the inclusion ratio for such property for generation-skipping transfer tax purposes. Section 114(f)(4) of the Bill would eliminate those Code provisions and enact a new Section 2625 which would reduce the amount subject to the generation-skipping transfer tax by the value of only those charitable interests which remain outstanding at the time the taxable event occurs. The effect of these changes will be to disregard completely the value of any charitable interest in a charitable lead trust when calculating the generation-skipping transfer tax on the remainder interest.

The present generation-skipping transfer tax as enacted in the 1986 Act treats equivalently various forms of split-interest gifts (gifts of interests to charity and to "skip persons" such as grandchildren) which have long been treated equivalently under established federal estate and gift tax valuation principles. Those valuation principles recognize that in every split-interest trust, the total value of the trust property is divided between the income and remainder interests, depending on the duration and payment terms of the income interest. The same valuation principles apply regardless of whether the charity has the income interest or the remainder interest. Both types of split-interest gifts are treated in the same manner as simultaneous gifts of equivalent values to charity and family beneficiaries. The amendments proposed in Section 114(f)(4) of the Bill would create arbitrary and illogical distinctions in the treatment of different forms of charitable giving, depending on whether the charity has an outright gift, an income interest or a remainder interest. Moreover, the application of proposed new Section 2625 is technically unclear in the context of certain split-interest gifts involving charitable beneficiaries.

There is no indication in the legislative history of the enactment of the generation-skipping transfer tax provisions of the 1986 Tax Reform Act that these distinctions were ever contemplated. The nonequivalent treatment of equivalent values of charitable interests not only contravenes established transfer tax principles, but is clearly a substantive change in the law rather than a technical correction. We therefore recommend that §114(f)(4) of the Bill be deleted in its entirety, and that the present provisions of Section 2642 of the Code remain intact.

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COMMENTS OF THE STOCK COMPANY INFORMATION GROUP
TO THE COMMITTEE ON FINANCE OF THE
UNITED STATES SENATE
CONCERNING S. 1350,
THE TECHNICAL CORRECTIONS ACT OF 1987

The Stock Company Information Group appreciates this opportunity to submit comments to the Committee on Finance with respect to S. 1350, the Technical Corrections Act of 1987. The Stock Company Information Group (the "SIG") consists of 28 investor-owned life insurance companies. Taking into account its members' affiliated companies, the SIG includes a majority of the 50 largest life insurance companies in the United States. The SIG was organized in 1981 to monitor tax legislative developments and to convey the views of its membership on life insurance tax issues to the various insurance trade associations and to the Government. The SIG has been privileged to work closely with the Committee and its staff in connection with the development of the insurance tax provisions of the Tax Equity and Fiscal responsibility Act of 1982, the Deficit Reduction Act of 1984 (the "1984 Act"), and the Tax Reform Act of 1986 (the "1986 Act"). A list of the SIG member companies appears at the end of this statement.

I. Introduction.

Our comments are limited to several aspects of the new corporate alternative minimum tax ("AMT") which are of concern to stock life insurance companies. Under the AMT, a corporation's alternative minimum taxable income ("AMTI") will be adjusted to include a portion of what have been characterized as "business untaxed reported profits." In 1987, 1988, and 1989, this adjustment will be based on "net book income," while in 1990 and ensuing years the adjustment will be based on "adjusted current earnings." The problems we see under these adjustments are as follows:

(1) All mutual life insurance companies (and some stock companies) will use their annual statement gain or loss from operations in determining the amount (if any) of the book income adjustment, while many stock life insurance companies will determine that amount from a GAAP financial statement, which typically will show a larger amount of "book income."

(2) Under both the book income and the current earnings adjustment, the small life insurance company deduction is in effect treated as a preference item, i.e., a small life insurance company otherwise eligible for the effective rate reduction granted by the small company deduction is denied the benefit of that reduction through the AMT.

(3) During the years 1987-89, mutual life insurance companies will receive a greater deduction for policyholder dividends in computing AMTI than they will receive in computing regular taxable income and in computing adjusted current earnings in 1990 and thereafter.

In order to correct these problems, the Stock Company Information Group recommends that the following three changes be made in the AMT:

(1) Book income should be defined, in the case of all life insurance companies, as annual statement gain or loss from operations (before Federal income tax).

(2) The small life insurance company deduction should not be treated as a preference item. Specifically, book income or current earnings, as the case may be, should be reduced by the amount of the small company deduction allowed in determining a company's regular taxable income.

(3) In computing book income under the AMT, a mutual life insurance company should be allowed to deduct only those policyholder dividends which are deductible in computing regular taxable income.

A discussion of each of these problems and recommendations follows.

II. The "book income" of life insurance companies should be measured by annual statement accounting.

A. Background

1. Regular Taxable Income

In determining the regular taxable income of a life insurance company, the Code generally uses the figures reported by the company on the annual statement the company must file with State insurance regulators. This statement follows the form prescribed by the National Association of Insurance Commissioners to carry out the accounting requirements imposed on insurers by State statutes and regulations; hence the oft-used reference to annual statement accounting as "statutory" accounting. In instances where the tax rules require a departure from the annual statement figures, as in the case of life insurance reserves under section 807(d), the figures specially computed for tax purposes are derived from annual statement data.

Thus, annual statement accounting is the touchstone for tax accounting. Indeed, mutual life insurers and some stock life insurers have no formal financial report other than the annual statement. On the other hand, many stock life insurers (including the largest stock life insurers) prepare audited GAAP financial statements, either for purposes of SEC filings or for other purposes.

In formulating the life insurance company provisions of the 1984 Act, Congress paid considerable attention to the effect that those provisions would have on competition between mutual and stock companies. As part of the 1984 law, Congress allocated 55 percent of the life insurance industry's tax for the year 1984 to mutual companies and the remainder to stock companies. (I.R.C. section 809 contains a mechanism for reallocation in subsequent years.)

2. The Alternative Minimum Tax

Under the book income adjustment, a life insurance company's AMTI will be increased by one-half of the excess (if any) of the company's "book income" over the company's "pre-book alternative taxable income" (generally, its regular taxable income plus any other enumerated preference items). The company's "book income" is the net income shown on its "applicable financial statement." A life insurance company's applicable financial statement will be either a financial statement filed with the SEC, or if it has no such statement, a certified audited GAAP financial statement, or if it has neither of the foregoing, the NAIC annual statement filed with State regulators.

B. The Problem under the Alternative Minimum Tax

The "book income" adjustment does not treat stock and mutual life insurance companies equally, *i.e.*, the AMT is not a level playing field. As noted above, many stock life insurance companies prepare GAAP income statements, but no mutual life insurers do (other than for internal analytical purposes). Thus, all mutual life insurance companies (and some stock companies) will use their annual statement gain or loss from operations in determining the amount (if any) of the book income adjustment, while many stock life insurance companies will determine that amount from a GAAP financial statement. The differences between a life insurance company financial statement prepared in accordance with generally accepted accounting principles and one prepared in accordance with statutory accounting principles frequently are substantial, with a GAAP statement typically showing a larger amount of "book income." These differences could give mutual life insurance companies a competitive advantage over many stock life insurance companies.

C. Recommendation

In order to treat all life insurance companies equally under the AMT during the years 1987, 1988, and 1989, book income should be defined for all life insurance companies as annual statement gain or loss from operations (before Federal income tax). A suggested amendment appears at the end of this statement.

D. Discussion

Just as annual statement accounting has long been the basis for determining the tax liability of life insurers, it should also be of primary relevance in any minimum tax computation. In contrast to other industries where there may be no single, common method of computing book income, the life insurance industry has a nationally uniform set of non-tax books — the annual statement filed with State regulators. Treating the annual statement gain from operations of life insurers as their exclusive book income will help to ensure an even-handed application of the AMT industry-wide. It would also accord with the 1986 resolution of the National Association of Insurance Commissioners urging Congress to require the use of statutory insurance accounting principles (i.e., the annual statement) in any book income preference computation.

Uniformity aside, as recently as 1984 Congress thoroughly reviewed the tax treatment of life insurance companies, including the long-standing practice of the tax law to make use of annual statement data as the basis of tax computations. Rather than depart from the use of the annual statement, Congress reaffirmed it as the source of the tax computations. Although other types of earnings statements were known to Congress at that time, they were not employed for the following reasons: (1) a significant number of life insurance companies (including the three largest life insurance companies in the Nation) do not have any financial statement other than the annual statement; and (2) other financial statements will show differences from the annual statement primarily in timing rather than in "permanent" items. These reasons are equally persuasive as to why the annual statement should be used in the AMT.

In sum, to preserve the well considered decisions made by Congress in enacting the life insurance company provisions of the 1984 law, and to ensure a level playing field between segments of the industry, the annual statements that all life insurance companies file with their State regulators (and which are audited by those regulators) should provide the exclusive basis for determining the book income of such companies.

III. The benefit of the small life insurance company deduction should not be reduced by the alternative minimum tax rules

A. Background

Under section 806, qualifying small life insurance companies may claim the benefit of the "small life insurance company deduction" in computing their regular taxable income. This deduction, enacted as part of the 1984 life insurance tax legislation in place of similar rules under prior law, was intended to reduce the tax rates applicable to eligible small companies. As noted in the House and Senate Reports accompanying the 1984 Act, the small life insurance company deduction results "in effect in a lowering of the tax rates on LICTI" (life insurance company taxable income). See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1404 (1984); S. Prt. No. 169, Vol. 1, 98th Cong., 2d Sess. 528 (1984).

B. The Problem Under the Alternative Minimum Tax

Under both the book income and the current earnings adjustments, the small company deduction is in effect treated as a preference item, i.e., a small life insurance company otherwise eligible for the rate reduction granted by the small company deduction is denied the benefit of that rate reduction under the AMT.

C. Recommendation

The small life insurance company deduction should not be treated as a preference item. Specifically, the AMT should be amended to provide that adjusted current earnings or book income, as the case may be, are to be reduced by the amount of the small company deduction allowed in determining the company's regular taxable income. A suggested amendment appears at the end of this statement.

D. Discussion

Because the amount of the small company deduction is a percentage of an eligible company's otherwise taxable income, the deduction can only reduce the company's tax rate. It cannot produce a loss. The policy behind this deduction has been reaffirmed by its retention by the Tax Reform Act of 1986, which specifically rejected the President's proposal to repeal the deduction.

The 1986 Act, moreover, does not treat other instances of rate relief (such as the graduated rates for smaller corporations) as a preference item subject to the minimum tax. Since the small life insurance company deduction functions in the same way — rate relief for small life insurance companies — it, too, should not be treated as a preference item.

IV. Mutual life insurance company policyholder dividends should not be fully deductible for purposes of the book income adjustment

A. Background

For more than sixty years Congress has, directly or indirectly, but without exception, limited the extent to which policyholder dividends paid by a mutual life insurance company can be deducted in computing the company's regular taxable income. Currently, in computing taxable income under subchapter L of chapter 1 of the Code, a portion of the policyholder dividends paid by a mutual life insurance company is explicitly disallowed as a deduction. The amount disallowed is determined under I.R.C. section 809.

The limit on dividend deductibility fixed by section 809 is an integral part of the comprehensive 1984 revisions to the taxation of life insurance companies. The section 809 limit was adopted only after extended consideration. In enacting this limit, Congress recognized that part of a mutual life insurance company's policyholder dividends represents a price rebate to its customers and should be deductible in computing corporate-level income. Part, however, is a distribution of corporate income to the corporation's owners (similar to dividends to shareholders), and like other distributions of corporate income should not be deductible in computing taxable income. The limitation determined under section 809 was intended by Congress to measure this nondeductible corporate income element. See H.R. Rep. No. 432, Pt. 2, supra, at 1422; S. Prt. No. 169, Vol. I, supra, at 547-49.

The section 809 limitation on a mutual life insurance company's policyholder dividend deduction is equally applicable in determining adjusted current earnings. As explained in the Joint Committee's General Explanation of the Tax Reform Act of 1986 (at pages 457-58):

> In general, adjusted current earnings requires the same treatment of an item as used for purposes of computing unadjusted alternative minimum taxable income. Thus, for example, deduction disallowances or limitations that apply for purposes of determining regular taxable income and alternative minimum taxable income also apply for purposes of determining adjusted current earnings (e.g., the disallowance of a deduction for bribes and kickbacks (sec. 162(c)) or for penalties (sec. 162(f)), and and the limitation on the deduction for policyholder dividends (sec. 808(c)(2)).

B. The Problem under the Book Income Adjustment

The striking anomaly that has arisen under the book income adjustment is that policyholder dividends of a mutual life insurance company, which are not fully deductible in computing regular taxable income, or in computing adjusted current earnings, nevertheless appear to be fully deductible in computing the book income adjustment.

Under the "book income" adjustment, a life insurance company's AMTI will be increased by one-half of the excess (if any) of the company's "book income" as shown on its "applicable financial statement" over its "pre-book alternative taxable income" (generally, its regular taxable income plus any other enumerated preference items). The applicable financial statement, in the case of a mutual life insurance company, is the company's NAIC annual statement which it files with state insurance departments. Thus, a mutual life insurance company's "book income" adjustment will be based on gain or loss from operations as reported on its annual statement. The annual statement, however, contains two potentially relevant statements of income: gain or loss from operations without a deduction for policyholder dividends, and gain or loss from operations with a deduction for policyholder dividends.

The statute (in section 56(f)) does not specify the use of either of these measures of income, nor does it give any indication of the extent to which policyholder dividends are to be taken into account in computing the adjusted net book income of a mutual life insurance company. The Conference Report accompanying the 1986 Act states, however, that "the conferees intend that the measure of pre-tax book income is the amount of net gain from operations after dividends to policyholders and before Federal income taxes." See H.R. Rep. No. 841, vol. II, 99th Cong., 2d Sess. 273 (1986).

C. Recommendation

The AMT should be amended to provide that in computing book income, a mutual life insurance company should be allowed to deduct only those policyholder dividends which are deductible in computing regular taxable income. A suggested amendment appears at the end of this statement.

D. Discussion

There are a number of sound policy reasons why a mutual life insurance company's deduction for policyholder dividends should be limited under the book income adjustment of the AMT in exactly the same way as that deduction is limited in computing regular taxable income and in computing adjusted cuurent earnings:

o Section 809 is the Congress's most current, and most carefully considered, assessment of the extent to which the deductibility of policyholder dividends should be limited for purposes of the regular corporate tax. That limitation will be in effect under the minimum tax starting in 1990. No basis exists for allowing a greater deduction for purposes of the minimum tax during the years 1987-89.

o Section 809 identifies that portion of a mutual life insurance company's policyholder dividends which should be treated as deductible rebates to customers and that portion which should be treated as nondeductible distributions of corporate income to the owners of the corporation. Other corporations cannot deduct dividends to owners in measuring their business untaxed reported profits, and mutual life insurance companies should not be treated more favorably than other corporations.

o If mutual life insurance companies are allowed an additional deduction for policyholder dividends in computing book income, it will probably be the only instance in which a taxpayer receives more favorable treatment under the minimum tax than under the regular tax. Moreover, it would virtually exempt many mutual life insurance companies from the alternative minimum tax. Such results would be contrary to the basic purpose of Congress in enacting a more stringent AMT.

V. Conclusion

In summary, the Stock Company Information Group recommends that the AMT be amended to provide that:

(1) In the case of all life insurance companies, book income is defined as annual statement gain or loss from operations (before Federal income tax).

(2) The small life insurance company deduction is not treated as a preference item.

(3) In computing book income, a mutual life insurance company may deduct only those policyholder dividends which are deductible in computing regular taxable income.

* * *

The member companies of the SIG thank the Committee on Finance for the opportunity to comment on these matters.

Respectfully submitted,

DAVIS & HARMAN

By: William B. Harman, Jr.

On behalf of the Stock Company Information Group

July 23, 1987

MEMBERS OF THE STOCK COMPANY INFORMATION GROUP

Aetna Life & Casualty Company
Allstate Life Insurance Company
American General Corporation
Business Men's Assurance Company of America
Capital Holding Corporation
CNA Insurance Company
CIGNA Corporation
Federal Kemper Life Assurance Company
Federal Home Life Insurance Company
Franklin Life Insurance Company
Hartford Life Insurance Company
E.F. Hutton Life Insurance Company
ICH Corporation
IDS Life Insurance Company
Integon Life Insurance Corporation
Jefferson-Pilot Life Insurance Company
Monarch Capital Corporation
Liberty Life Insurance Company
Life Insurance Company of Georgia
Life Insurance Company of Virginia
Lincoln National Life Insurance Company
Paul Revere Life Insurance Company
Provident Life and Accident Insurance Company
Torchmark Corporation
Transamerica Occidental Life Insurance Company
Travelers Insurance Company
UNUM Corporation
Washington National Insurance Company

Suggested Statutory Language

Measuring the "Book Income" of Life Insurance Companies by Annual Statement Accounting

To measure the "book income" of all life insurance companies by reference to the annual statement filed with state insurance regulators, the following sentence could be added to I.R.C. section 56(f)(3)(C).

> "For purposes of subparagraph (A), in the case of a life insurance company, the applicable financial statement shall be the annual statement within the meaning of section 809(g)(4)."

Treatment of the Small Company Deduction under the Alternative Minimum Tax

There are two alternative methods of ending the treatment of the small life insurance company deduction as a preference item in the alternative minimum tax. First, either net book income or adjusted current earnings, as the case may be, can be reduced by the amount of the small company deduction allowed in determining the company's taxable income. This result would be achieved by the following amendments:

Method I

(1) Add to I.R.C. section 56(f)(2) the following new subparagraph:

"ADJUSTMENT FOR CERTAIN SMALL LIFE INSURANCE COMPANIES. — In the case of a life insurance company, adjusted net book income shall be reduced by the amount (if any) of the small life insurance company deduction allowable under section 806."

(2) Add to I.R.C. section 56(g)(4) the following new subparagraph:

"ADJUSTMENT FOR CERTAIN SMALL LIFE INSURANCE COMPANIES. — In the case of a life insurance company, a deduction shall be allowed equal to the amount (if any) of the small life insurance company deduction allowable under section 806."

Method II

Alternatively, a life insurance company's alternative minimum taxable income could be determined without regard to the small life insurance company deduction. This result would be achieved by the following amendments:

(1) Add to I.R.C. section 56(f)(1)(B), after "deduction":

"and determined without regard to the amount (if any) of the small life insurance company deduction allowable under section 806."

(2) Add to I.R.C. section 56(g)(1)(B), after "deduction":

"and determined without regard to the amount (if any) of the small life insurance company deduction allowable under section 806."

Deductibility of Mutual Life Insurance Company Policyholder Dividends

To limit the deductibility of mutual life insurance company policyholder dividends in computing book income, the following subparagraph could be added to I.R.C. section 56(f)(2):

"TREATMENT OF MUTUAL LIFE INSURANCE COMPANY POLICYHOLDER DIVIDENDS.— In the case of a mutual life insurance company, in determining adjusted net book income a deduction shall be allowed for policyholder dividends paid or accrued during the taxable year equal to the amount of the deduction allowed in computing life insurance company taxable income under section 801(b)."

WRITTEN STATEMENT

OF

RYAL R. POPPA

My name is Ryal R. Poppa, and I am Chairman and Chief Executive Officer of Storage Technology Corporation (StorageTek). This statement is submitted for the record in connection with the Subcommittee's hearing on the Technical Corrections Act of 1987. StorageTek is seeking a clarification of the transition rule for pending bankruptcies that was included in the new net operating loss carryover rules that were adopted as part of the Tax Reform Act of 1986.

I. <u>Background</u>

StorageTek is engaged in the development and production of state-of-the-art computer disk and tape storage technology. StorageTek presently employs some 4,200 people in the State of Colorado, with a total of 8,500 employees located throughout the United States. StorageTek is the only U.S. firm other than IBM that produces such "high-end" computer data storage products. StorageTek now faces severe competitive pressure in international markets from two major Japanese firms, Fujitsu and Hitachi, whose trade practices recently have come to the attention of this Committee.

StorageTek recently underwent a period of severe financial distress that resulted in a Title 11 bankruptcy proceeding that began on October 31, 1984. After several years of arduous negotiations with its creditors, StorageTek is now in the process of winding up its bankruptcy proceeding. StorageTek filed its bankruptcy plan of reorganization with the court in early September, 1986. The reorganization plan received final approval from the court on June 18, 1987, and StorageTek expects to complete its distributions to creditors under the plan by the end of July. Under the reorganization plan, virtually all of the Company's pre-Chapter 11 liabilities would be settled with payment of cash, stock, and debentures representing 100 cents on the dollar of claim. Upon emergence from bankruptcy, StorageTek will be continuing in the same business and indeed plans to substantially increase its employment capacity because of a sharp upturn in orders of a new generation of sophisticated computer products.

A key feature of this plan of reorganization is the continued availability of the pre-86 Act net operating loss (NOL) carryover rules upon which the parties had relied during almost two years of arduous negotiations to formulate the reorganization plan that was filed with the court in September, 1986 (and ultimately approved by the court). Indeed, this feature is so crucial to the success of the reorganization that the availability of the then-current law NOL provisions is a condition precedent to the reorganization plan itself.

II. The Problem: As Presently Drafted, the NOL Transition Rule for Pending Bankruptcies May Not Achieve the "Fresh Start" Congress Contemplated

A. Rationale for NOL Transition Rule for Pending Bankruptcies

The basic thrust of the new NOL carryover rule in Code section 382 as amended by the 1986 Act is to place very substantial restrictions on the use of loss carryforwards by a corporation that has experienced an "ownership change", within the meaning of the statute. In general, such an "ownership change" is deemed to occur if one or more 5% shareholders of the corporation increase their aggregate percentage ownership by more than 50 percentage points over the lowest percentage such shareholders owned during the preceding three-year period.

Recognizing the unique circumstances associated with a bankruptcy reorganization, Congress adopted as part of the 1986 Act amendments to section 382 a transition rule for pending bankruptcies that was intended to continue the long-established then-current law rules upon which these pending reorganizations had relied. (Act section 621(f)(5)). StorageTek was heavily involved in the legislative effort that led to this transition rule for pending bankruptcies, and indeed StorageTek understands that the transition rule was included in response to its request and was drafted to cover its particular case.

At the time of this legislative effort, StorageTek understood that the transition rule was intended to retain then-current law in recognition of the difficulties which would result from a change in midstream of crucial tax rules upon which the parties to a pending bankruptcy had relied in negotiating and achieving a viable plan of reorganization. Accordingly, any stock that was issued in the bankruptcy reorganization would not be counted toward the 50 percent change in ownership threshold that would trigger application of the severe new NOL carryover restrictions. The continued availability of the pre-Act NOL rules for pending bankruptcies was seen as -- and remains -- crucial to the successful emergence of these affected corporations from bankruptcy by providing the necessary "breathing room" to reestablish economic health of the company.

Thus, StorageTek understands that the transition rule was intended to preserve for pending bankruptcies the "fresh start" ability to fully use existing NOL carryforwards that had long been enjoyed under then-current pre-Act law by companies emerging from bankruptcy.

B. Why the Transition Rule as Presently Drafted May Not Cover StorageTek's Pre-Act Bankruptcy

In its present form, the transition rule has an ambiguity that under a technical reading may be interpreted as preserving the then-current law NOL rules only for those pending bankruptcies in which the bankruptcy reorganization itself gives rise to a more-than-50-percent "ownership change". The transition rule provides in the case of a Chapter 11 proceeding that the 1986 Act amendments to Code section 382 "shall not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986." (Act section 621(f)(5)).

The problem is as follows. At the time of consideration of the 1986 Act, based upon the facts then available to it, StorageTek -- which was publicly-held all by fewer-than-5% shareholders -- believed that it was very susceptible to the statutorily-defined more-than-50-percent "ownership change" by 5% shareholders as part of its bankruptcy reorganization, which would trigger the restrictive new NOL carryover rules. Thereafter, because of StorageTek's very success in quickly turning around from a $500 million loss in the fourth quarter of 1984 to an initial level of profitability one year later followed by six straight quarters of positive earnings, the value of its creditors' claims has significantly increased. As a result, widespread public trading of StorageTek debt has been occurring, and, correspondingly, uncertainty has arisen over whether the debt will come to rest in sufficiently concentrated hands to constitute the requisite growth in interest of 5% shareholders -- all events over which StorageTek can exercise no control.

As noted above, all of the less-than-5% shareholders are aggregated and treated as a single 5% shareholder. In the case of the "owner shift" rules which are applicable to the conversion of debt to stock, this putative 5% shareholder is treated as the same historical shareholder before and after the stock-for-debt exchange. Hence, no shift in stock holdings counting toward an "ownership change" will be deemed to occur where old less-than-5% shareholders (whose equity is being extinguished) own, say, 60 percent of the company prior to reorganization and new less-than-5% former creditor shareholders own 60 percent after the reorganization, even though the two groups likely consist of entirely different persons.*/ In StorageTek's case, new shareholders will own approximately 85 percent of the total equity of the Company following the bankruptcy reorganization. However, more than 50 percent of the reorganized StorageTek's stock may or may not flow to 5% shareholders upon the stock-for-debt exchange -- depending on the vagaries of the debt trading results over which StorageTek has no control. This uncertainty associated with the public trading of StorageTek's debt has raised concern over whether StorageTek will be able to qualify for the pending transition rule as presently drafted because its bankruptcy reorganization may not rise to the level of the more-than-50 percent "ownership change" required under a technical reading of the rule.

By requiring that 5% shareholders receive more than 50 percent of the reorganized corporation's stock, the technical reading of the rule in effect conditions the availability of transition relief for bankruptcies pending at the time of the Act upon such fortuitous factors as whether the corporation's creditors are large or small in their debt holdings and whether trading in the company's debt prior to the reorganization will assemble small debt into large blocs or will fragment large blocs of debt among many unrelated holders. Consequently, the transition rule can be read to provide no relief at all for those pending bankruptcies in which more than 50 percent of the stock does not flow to 5% shareholders upon the reorganization. There appears to be no congressional intent to so limit the "fresh start" transition relief.

In summary, under a technical reading, the transition rule as presently drafted could be interpreted in a manner inconsistent with what we believe to be the clear congressional intent of providing "fresh start" NOL protection for <u>all</u> bankruptcies that were pending at the time of congressional action.

Proposal

StorageTek strongly urges that a technical correction be adopted with respect to the transition rule for pending bankruptcies to clarify that any increase in stock ownership occurring as part of a grandfathered bankruptcy reorganization should not be counted toward the 50 percent change in ownership threshold that would trigger the severe new NOL carryover restrictions -- even though such ownership increase may not necessarily rise to the level of an "ownership change" as statutorily defined. We believe that this clarifying technical correction can be drafted so as to include whatever reasonable safeguards the Members and staff of the Committee may deem necessary to ensure proper application of the rule.

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*/ We understand that the rule treating this putative 5% shareholder in effect as a continuing shareholder was intended to be helpful, rather than imposing a new restriction, for taxpayers.

SULLIVAN & CROMWELL July 14, 1987

Re: Treatment of Foreign Currency Gains for Purposes of Section 851(b)(3) of the Internal Revenue Code (Section 106(n)(2) of the Technical Corrections Act of 1987)

This memorandum discusses Section 106(n)(2) of the Technical Corrections Act of 1987 (the "Act"), which would modify the 30% of gross income requirement applicable to regulated investment companies.

Section 851(b)(3) of the Internal Revenue Code of 1986 (the "Code") provides that a regulated investment company must derive less than 30% of its gross income from the sale or other disposition of stock or securities held less than 3 months (the so-called "short-short" rule).* The Internal Revenue Service has stated that the purpose of this requirement is "to ensure that regulated investment companies engage primarily in safeguarding investments and securing investment returns consistent with safety of principal" and to prevent regulated investment companies

* For purposes of Section 851(b)(3) of the Code, losses from the sale or other disposition of stock or securities do not enter into the computation. Treas. Reg. § 1.851-2(b).

from "actively trading securities for the purpose of making short-term trading profits." Rev. Rul. 75-376, 1975-2 C.B. 267.*

Section 106(n)(2) of the Act would amend Section 851(b)(3) of the Code to provide that income taken into account for purposes of the short-short rule includes, among other types of income, gross income derived from the sale or disposition of options, futures or forward contracts held for less than 3 months and, except as may be provided in regulations, foreign currency held for less than 3 months.** That provision would apply retroactively to taxable years beginning after October 22, 1986.

We view that provision of the Act, particularly as it relates to foreign currency, as problematic in several regards. First, while the provision applies to income from the sale or disposition of "foreign currency", no definition of "foreign currency" is provided. It is therefore unclear whether Section 106(n)(2) of the Act would include only

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* The General Explanation of the Tax Reform Act of 1986 states on page 377 that the short-short requirement "is an appropriate requirement to ensure that a [regulated investment company] is a passive entity."

** The explanation of the Act prepared by the Staff of the Joint Committee on Taxation states on page 56 that "the bill clarifies that the 30 percent test is applied with respect to sales or dispositions of . . ., options, futures or forward contracts; or, except as provided in regulations, foreign currencies."

income from the actual sale or disposition of nonfunctional currency,* or whether it would also apply to any "foreign currency gain" as defined in Section 988(b)(1) of the Code. If it is intended to apply to the latter, Section 106(n)(2) of the Act presumably would include foreign currency gains attributable to the 3 month period before any "payment date" (as that term is defined in Section 988(c) of the Code).

If Section 106(n)(2) of the Act is intended to apply to any "foreign currency gain" attributable to the 3 month period before a payment date, we believe it inappropriately sweeps into Section 851(b)(3) of the Code income which is wholly unrelated to the purpose of the short-short rule and represents a significant expansion of present law. For example, foreign currency gains attributable to exchange rate fluctuations between the trade date for the purchase of an instrument and the settlement date relating to that purchase may be counted for purposes of the short-short rule. Furthermore, foreign currency gains

* For purposes of computing a taxpayer's foreign currency gains and losses, Section 988(c) of the Code defines "nonfunctional currency" as including coin or currency as well as any nonfunctional currency denominated demand or time deposit or similar instruments issued by a bank or other financial institution. That definition therefore suggests that "foreign currency" for purposes of Section 106(n)(2) of the Act should be limited to coin or currency and demand or time deposits or similar instruments issued by a bank or other financial institution.

realized upon receiving principal payments on a foreign currency denominated debt instrument within 3 months of the instrument's acquisition (including principal payments on short-term debt instruments having maturities of less than 3 months) may be counted for purposes of the short-short rule. Similarly, foreign currency gains realized upon the receipt of interest payments on a foreign currency denominated bond (or the receipt of the redemption price on an instrument bearing original issue discount in foreign currency units) might also result in short-short income to the extent attributable to interest (or original issue discount) accrued during the 3 months prior to payment.

Such gains are attributable solely to exchange rate fluctuations, which are beyond the control of a regulated investment company, and do not create the "short-term trading profits" intended to be restricted by Section 851(b)(3) of the Code. We therefore believe that Section 106(n)(2) of the Act cannot be interpreted as applying to "foreign currency gains" as defined in Section 988(b)(1) of the Code.

Even if Section 106(n)(2) of the Act is interpreted as applying only to actual dispositions of non-functional currency, that provision represents a significant expansion of current law and, we believe, serves no useful purpose.

We recognize that regulations may limit the extent to which gains from the disposition of foreign currencies will be included for purposes of Section 851(b)(3) of the Code, but until such regulations are issued Section 106(n)(2) of the Act would, if enacted, create unwarranted uncertainty and confusion. That provision would also require regulated investment companies to establish burdensome bookkeeping systems to monitor the foreign currency gains taken into account for purposes of the short-short rule. Furthermore, because it applies retroactively, that provision has the potential for causing a corporation to fail to qualify as a regulated investment company because of transactions which the corporation had no reason to believe, at the time the transactions were completed, would give rise to income described in Section 851(b)(3) of the Code.

In view of the foregoing, we recommend that Section 106(n)(2) of the Act be modified to delete the provision relating to gains from foreign currency. The extent to which foreign currency gains should be included for purposes of the short-short rule is not an appropriate issue to be addressed in a technical corrections bill and cannot be addressed adequately by an amendment to the Code.

Randall K.C. Kau
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SULLIVAN & CROMWELL

Double Taxation of Interest Received by U.S. Broker-Dealers on Inventories of U.S. Securities Held in Foreign Countries

Background

In general, U.S. firms have conducted the business of being dealers in securities in foreign countries through controlled foreign corporations ("CFCs") rather than branches because of the need to comply with the requirements of various jurisdictions -- principally the United States, the United Kingdom, Japan, and Switzerland. See, generally Department of the Treasury, National Treatment Study: Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations (December 18, 1986). Each of these countries taxes firms conducting a securities business at ordinary income rates currently ranging from 35% in the United Kingdom to 57% in Japan on the income derived within the taxing jurisdiction. This will include, among other items, interest, dividends, and net gain on securities held for sale to customers in the ordinary course of the trade or business.

The Tax Reform Act of 1984 and the Tax Reform Act of 1986 (the "Reform Act") included a number of provisions which have had a profound impact on the issuance and distribution of securities by U.S. borrowers, including the United States Treasury. In particular, the repeal of the 30% withholding tax on portfolio interest and the promulgation by the Treasury and Internal Revenue Service of implementing regulations has resulted in U.S. borrowers obtaining direct access to international capital markets. Net purchases by foreigners of U.S. corporate bonds increased from $903 million in 1983 to $43.5 billion in 1986. Net foreign purchases of U.S. Treasury notes and bonds rose from $3.7 billion in 1983 to $24.3 billion in 1986.

Problem

The interest income which accrues on bonds of U.S. issuers while held in inventory of a dealer in securities is treated as U.S. source income under generally applicable rules. Section 861(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). Where the dealer is a U.S. owned foreign corporation, interest, dividends, and Subpart F amounts derived by a U.S. shareholder from its U.S. owned corporation must be treated as U.S. source income to the extent provided by Section 904(g) of the Code, notwithstanding the fact that a foreign country may have imposed tax on such income. Thus if the U.S. shareholder is subject to an effective foreign tax credit limitation by reason of not having sufficient foreign source taxable income, it will be subject to double taxation.

U.S. shareholders of controlled foreign broker-dealers cannot avoid this double taxation of U.S. source interest on their inventories of debt securities. Section 881(c)(4)(A) of the Code overrides all the exclusions from Subpart F in the case of portfolio interest received by a CFC, including the exclusion in Section 954(b)(4) of the Code for items of income subject to an effective rate of foreign income tax greater than 90% of the maximum U.S. statutory rate. This double taxation places U.S. controlled broker dealers at a severe competitive disadvantage vis-a-vis foreign-owned broker-dealers.

Recommendation

To deal with the foregoing problem, the Subcommittee on Taxation of International Operations (the "Subcommittee") of the Tax Policy Committee of Securities Industry Association makes the following two recommendations:

1. Section 881(c)(4)(A)(ii) of the Code should be deleted.

Comment: This amendment is appropriate because Section 954(b) and (c) of the Code relating to the exclusions from Subpart F were substantially amended by the Reform Act.* Deletion of the reference in Section 881(c)(4)(A)(ii) to Section 954(b)(4) of the Code would result in an exclusion from Subpart F for CFCs receiving portfolio interest only if such income is subject to an effective rate of income tax imposed by a foreign country greater than 90% of the maximum rate of tax imposed on domestic corporations. Because the Reform Act eliminated the subjective test of prior law, the objective test now in the Code provides assurance that the exclusion will not be availed of in countries which are "tax havens."

2. Section 112(z)(4) of H.R. 2636, the Technical Corrections Act of 1987, as introduced on June 10, 1987, should be amended by striking lines 5 through 21 on page 376 and inserting in lieu thereof:

"(10) EXCEPTION FOR INCOME SUBJECT TO FOREIGN INCOME TAX. -- If --

(A) any amount derived from a United States-owned foreign corporation would be treated as derived from sources within the United States under this subsection by reason of an item of income of such United States-owned foreign corporation, and

(B) such item of income bears an effective rate of income tax of at least 10 percent,

this subsection shall not apply to such amount to the extent attributable to such item of income."

Comment: Section 112(z)(4) of the Technical Corrections Act of 1987 would amend Section 904(g) of the Code by overriding the re-sourcing rule where a treaty obligation of the United States otherwise provides. Any income, however, would be subject to a separate limitation to the extent attributable to an item of U.S. source income earned by the foreign corporation.

Although the technical amendment is a step in the direction of ameliorating a serious double taxation problem, it relies in the first instance on provisions of a tax treaty governing source. In many instances, the treaties, particularly older treates, are silent or ambiguous as to source. In the case of modern treaties, including those with major countries in which financial centers are located (Australia, Canada, Japan, the United Kingdom, and Switzerland), the availability of treaty protection against double taxation by reason of conflicting source rules is ambiguous at best.

The Subcommittee respectfully submits that the double taxation of a U.S. taxpayer can occur whether or not there is a tax treaty. Accordingly, the principle which Section 112(z)(4) of the Technical Corrections Act should incorporate is that Section 904(g) will not apply to any amounts derived from a foreign corporation where the country in which the foreign corporation is resident exercises the primary right under international law and custom as the country of residence to tax its residents and subjects such income to a rate of tax of at least 10%. This concept is similar to that now included in Section 865(e)(1)(B) of the Code (relating to the source of income derived by a United States resident on sales of certain personal property attributable to an office or other fixed place of business outside the United States) and Section 865(g)(2) of the Code (relating to the definition of a United States citizen or resident alien for purposes of determining the source of any sale of personal property). In each of these situations, the source of income is treated as foreign notwithstanding conflicting rules and regardless of the presence or absence of a tax treaty if the taxpayer is subject to an actual rate of income tax of at least 10%.

The Senate Finance Committee explained the purpose of Section 865(e)(1)(B) of the Code as follows:

> "The committee does not intend that a taxpayer with an active business in a legitimate taxing jurisdiction that derives income connected with that business generate only U.S. source income. For example, the committee believes that income that a U.S. corporation generates in a foreign country through a fixed place of business should generally be local source income as long as the foreign country is not a tax haven with respect to the income at issue. Similarly, the committee believes that income derived from the disposition of business assets (for example, recapture income) should be sourced in the jurisdiction in which those assets were used in order to reflect the location of the economic activity generating the income." S. Rep. No.99-313, 99th Cong. 2d Sess. at p. 330 (May 29, 1986).

Although the foregoing discussion technically related to the source of gain derived by a United States person on certain sales of personal property, the principles set forth are equally applicable to the interest income derived by a controlled foreign corporation which is a dealer in securities conducting its business in a foreign jurisdiction which is not a tax haven.

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* Section 112(h)(17) of the Technical Corrections Act, at p. 340, lines 16-18 makes the change recommended in the text, but lines 19-21 restores the reference in Section 881(c)(4)(A)(ii) of the Code to Section 954(b)(4) of the Code. No explanation is provided in the Staff of the Joint Committee Description of the Technical Corrections Act of 1987.

SULLIVAN & CROMWELL

Re: Section 106(n)(1) of the Technical Corrections Act of 1987

This memorandum discusses our views with respect to Section 106(n)(1) of the Technical Corrections Act of 1987 (the "Act") which would modify the definition of income that counts towards satisfaction of the 90 percent of gross income test applicable to regulated investment companies.

Section 851(b)(2) of the Internal Revenue Code of 1986 (the "Code") provides that a corporation will not qualify as a regulated investment company unless, among other things,

> "at least 90 percent of its gross income is derived from dividends, interest, payments with respect to securities loans . . . and gains from the sale or other disposition of stock or securities . . . or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities or currencies".

Under current law, a regulated investment company investing in a partnership takes into account its distributive share of the individual items of partnership income for purposes of the 90 percent of gross income requirement of Section 851(b)(2) of the Code.* A similar rule applies with

* See Private Letter Ruling 8416018 (January 13, 1984). In that ruling, the Internal Revenue Service noted that, under the approach adopted in that ruling, "if the partnerships in issue make the passive investments and hold the diversified types of assets required under Section 851 of the Code the taxpayer will not be put in a worse position by owning such assets through the partnership than if the taxpayer directly invested in its proportionate share of the partnership assets."

See Private Letter Ruling 8131049 (May 7, 1981).

respect to a regulated investment company's share of income of a trust.* Thus, a regulated investment company's share of partnership or trust income that is income described in Section 851(b)(2) of the Code will constitute qualifying income, and its share of partnership or trust income that is not described in Section 851(b)(2) will not be qualifying income.

Section 106(n)(1) of the Act provides that, for purposes of Section 851(b)(2) of the Code, "other income" derived with respect to a regulated investment company's business of investing in stocks, securities or currencies does not include "partnership or trust income." The description of the Act prepared by the Staff of the Joint Committee on Taxation states on page 56 that the Act "clarifies that income derived by the [regulated investment company] from a partnership or trust is not income that is considered to be derived with respect to the [regulated investment company's] business of investing in stocks, securities or currencies."

Section 106(n)(1) of the Act is apparently in response to a statement on page 382 of the General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, that "Congress did not intend that a [regulated investment company's] distributive share of income from a partnership interest would be treated as qualifying income derived with respect to the [regulated investment company's] business of investing in securities without regard to the character of the income derived from the partnership." A footnote to that statement indicates that a technical correction may be necessary to reflect this intention.

If enacted in its present form, Section 106(n)(1) will make it unclear whether a regulated investment company's share of partnership or trust income which is of a type described in Section 851(b)(2) of the Code (i.e., dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock, securities or foreign currencies) will constitute qualifying income. Furthermore, contrary to the language quoted in the preceding paragraph, it will also mean that "other income" described in Section 851(b)(2) of the Code (e.g., gains from options, futures and forward contracts) will never be qualifying income when earned through a partnership or trust.

In view of the rules established under current law, we do not believe that Section 106(n)(1) of the Act is necessary in order to ensure that a regulated investment company's share of partnership or trust income that is not described in Section 851(b)(2) will not be qualifying income to the regulated investment company.

If a provision with respect to partnership and trust income is to be included in the Act, we suggest that it simply confirm that the 90 percent of gross income requirement of Section 851(b)(2) of the Code is to be applied by looking at the regulated investment company's share of the income of the partnership or trust.

Sharp Sorensen

July 2, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Sir:

RE: IRC Sec. 501(m)
Technical Corrections Act, 1987 (H.R. 2636)

Experience has taught that an ambiguous statement in the law leads to confusion, numerous interpretations, uncertainties and law suits. I request that loss of time and costs be avoided by clearly stating in the Technical Corrections Act of 1987 (H.R. 2636) that charitable gift annuities are not subject to IRC Sec. 501(m).

It has been the policy of the U.S. Government to encourage charitable giving and charitable organizations have used gift annuities for over 100 years as one source of charitable giving. Charities are permitted to immediately use a portion of the annuity purchase funds for their charitable purposes.

Charitable gift annuities do not compete with commercial annuities and are not "commercial-type insurance." H.R. 2636 can be amended to clarify any doubts in the minds of those who do not understand charitable gift annuities.

Many small donors use the charitable gift annuity as an avenue to assist the charity of their choice. Please do not deny these donors this privilege. Amend H.R. 2636 by clearly stating that charitable gift annuities are not subject to IRC Sec. 501(m).

Sincerely,

S. A. Summers

Sunshine A. Summers (Mr.)

78-959 1528

SUTHERLAND, ASBILL & BRENNAN

STATEMENT WITH RESPECT TO THE
TREATMENT OF UNREALIZED
APPRECIATION ON EMPLOYER SECURITIES
FOR PURPOSES OF THE TAX ON
"EXCESS DISTRIBUTIONS" FROM
RETIREMENT ARRANGEMENTS

Submitted by
George H. Bostick
W. Mark Smith
Sutherland, Asbill & Brennan
Washington, D.C.

A number of employers have maintained for many years profit-sharing or other qualified plans under which significant portions of the individual accounts of participating employees may be invested in stock of the employer corporation. On retirement, plan participants frequently opt to receive such stock as an "in kind" distribution from the plan and hold it until their retirement needs or stock market conditions warrant disposing of it.

One of our clients maintaining such a plan asked that we call to the attention of the Committee an ambiguity as to the treatment of the appreciation in such stock from the time it was purchased within the plan to the date of distribution to the participant (the "unrealized appreciation") for purposes of the additional tax on distributions in excess of specified amounts imposed by the Tax Reform Act of 1986. Absent a technical correction, the statute may be read as imposing this additional tax in circumstances that were not contemplated.

Section 1133 of the Tax Reform Act of 1986 (adding Code section 4981A) imposes a 15 percent excise tax on aggregate "excess distributions" from qualified plans, IRAs and certain other retirement arrangements that receive beneficial tax treatment. The statute does not clearly indicate, however, whether unrealized appreciation on employer securities is taken into account in determining whether distributions exceed those permitted without imposition of the excise tax.

Generally, the unrealized appreciation on securities of an employer corporation that are distributed from, for example, a profit-sharing plan is not immediately taxable to the participant receiving such a distribution. Rather, the unrealized appreciation is included in taxable income when the recipient sells the securities. This rule involves two considerations: (1) the distributed securities themselves do not provide cash with which to pay tax and, depending on market conditions, the participant may wish to hold the securities in anticipation of an increase in their value; and (2) if the employer securities had been purchased by the employee outside the plan, unrealized appreciation also would not be taxable until the securities were sold. In light of the second factor, it is questionable whether deferred taxation of the unrealized appreciation component of employer securities distributed from a plan in fact involves any so-called "tax subsidy" of the sort that the new section 4981A rules (together with the Code section 415 rules) are designed to limit.

The absence of a clear statutory rule excepting unrealized appreciation from the amounts that enter into the calculation of excess distributions may have been simply an oversight. Section 1133 of the Act originated in the House version of the bill, without any corresponding provision in the Senate bill. The Ways and Means Committee report indicates that only the taxable portion of a distribution would be taken into account under section 4981A. That report expressly states that, "In applying the limit, aggregate annual distributions made with respect to a participant . . . generally are to be taken into account to the extent includible in gross income." H. Rep. 99-426, 99th Cong., 1st Sess. 745 (1985) (emphasis added).

Code section 4981A(c)(2) currently excludes the following types of untaxed distributions from the 15% tax:

- Amounts representing a return of the individual's after-tax contributions or other amounts included in investment in the contract;
- Amounts excluded from income because they are rolled over to another plan or IRA; and
- Amounts excluded from the participant's income because they are paid and taxed to a former spouse under a qualified domestic relations order.

The technical corrections bill (section 111A(g)(3)) further clarifies the applicability of the excise tax by specifically adding two more categories of untaxed distributions to the list of exclusions:

- An individual's investment in the contract under an IRA; and
- The value of an annuity contract distributed to an individual without being taxed at the time of distribution. Payments made under the contract are taken into account for purposes of the 15% tax, presumably to the extent they are taxable.

Accordingly, the 15% excise tax generally is structured to correspond to, not conflict with, the inclusion or exclusion of distributions in income. In particular, to the extent Congress previously has determined to afford a continued deferral of taxation on certain distributions (i.e., rollovers and distributed annuity contracts), those distributions are not viewed as "excess distributions" for purposes of the 15% excise tax.

These principles are equally applicable to the unrealized net appreciation in employer securities distributed from a qualified plan, which may be the only category of untaxed distribution omitted from the list of excluded distributions. Imposing the excise tax on such amounts would clearly conflict with the considerations underlying the exclusion of those amounts from income, discussed above. Indeed, given the comparable tax treatment of appreciation in stock purchased inside and outside a qualified plan, and thus the absence of a special tax subsidy, exclusion from the excise tax is particularly justified.

While we believe that section 4981A is properly read, in light of its legislative history, to not take account of net unrealized appreciation in employer stock, we suggest that an express exclusion be incorporated into section 4981A(c)(2) to clarify that result.

SUSQUEHANNA UNIVERSITY
Selinsgrove, Pennsylvania 17870

OFFICE OF UNIVERSITY RELATIONS

July 17, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
SD 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I was quite concerned to learn that a very serious threat to the future of charitable lead trusts has appeared in the current language of the Technical Corrections Bill. The proposed change regarding charitable lead trusts goes beyond a technical clarification and is very much a substantive one that appears to be contrary to the existing intent of Congress to encourage charitable gifts.

Specifically, the Technical Corrections Bill would repeal the inclusion of the charitable deduction in computing the Generation Skipping Transfer Tax (GSTT) on lead trusts created after June 10, 1987. This would most assuredly discourage the creation of many charitable lead trusts.

Because charitable lead trusts are most often written for large amounts, they result in very major gifts to charitable institutions. The payments that these trusts make to charities over the years can account for millions of dollars for non-profit organizations that can build libraries, fund endowments and in general contribute substantially to an institution's ability to offer high quality service.

Charitable lead trusts are an extremely important source of charitable giving for colleges and universities. I have been a fund-raiser for such institutions for a dozen years, and I can assure you that the serious curtailment in the use of such instruments that would result from the current bill would have a most unfortunate impact on our ability to raise significant amounts of funds.

Your efforts to keep the charitable deduction in the Generation Skipping Transfer Tax's "inclusion ratio" formula will be most deeply appreciated.

Sincerely,

Sara G. Kirkland

Sara G. Kirkland
Vice President
University Relations

SGK/gls

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DONALD B. SUSSWEIN
PARTNER

July 24, 1987

The Honorable Max S. Baucus
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
706 Hart Senate Office Building
Washington, DC 20510

Re: REMIC Provisions of Technical Corrections Act

Dear Senator Baucus:

This comment letter, including the enclosed technical appendix, on selected aspects of the proposed Technical Corrections Act relating to the treatment of Real Estate Mortgage Investment Conduits (REMICs), is submitted on behalf of our client, Salomon Brothers Inc.

Salomon Brothers has been a pioneering firm in the development of mortgage backed securities for more than 15 years, and is proud of its leading role, working with the Congress, in the development of mortgage finance industry proposals that led to the enactment of the landmark REMIC provisions of the Tax Reform Act of 1986.

The REMIC provisions of the 1986 Act were intended by Congress to increase the availability, and decrease the cost, of mortgage capital for homeowners and others by improving the efficiency of the secondary mortgage market. The specific goal of the REMIC provisions was to enable users of mortgage capital to compete fairly in the capital markets by eliminating inefficiencies imposed by the absence of fair and sensible rules for the structuring and taxation of multiple class mortgage related securities. The success of the REMIC provisions has been clearly demonstrated by the substantial volume of REMICs issued since the Tax Reform Act was signed into law.

Since January 1, 1987, over $20 billion of REMIC securities have been publicly issued by a variety of issuers including affiliates of thrift institutions and mortgage bankers, homebuilders, secondary market agencies, investment bankers, and other traditional participants in the secondary mortgage market.

The staff of the House and Senate tax writing committees, the staff of the Joint Committee on Taxation, and the Office of Tax Policy of the Treasury Department are to be commended for the diligence with which the final provisions of the Act were crafted. Given the technical complexity of the area, and the time pressures under which the final Conference Report was agreed to and drafted, the issuance of over $20 billion of a newly authorized security is a testament to the skill of the professional staff involved in the tax writing process.

As in any legislative effort, however, technical drafting errors are inevitable. In addition, as practitioners begin to work with a statute, new insights develop as to the best technical approach to implementing Congressional intent. The points that follow are intended to comment on the specific proposed technical corrections contained in the Technical Corrections Act as introduced by Chairman Bentsen, and to suggest additional areas where statutory corrections and modifications are necessary, in our view, to implement the goals and intentions of the Congress.

In particular, we believe technical corrections should be adopted to make the REMIC provisions as flexible as possible, in light of Congress' intent to establish them as the exclusive vehicle for multiple class mortgage backed securities. Multiple class mortgage backed securities are a critical link in the housing finance delivery system, and have become a significant part of the world-wide capital markets. In light of their demonstrated importance to housing, and their essentially non-tax motivated nature, we believe the guiding rule should be to permit as broad a category of transactions as possible under the REMIC rules, not to artificially limit REMICs where there is no legitimate tax policy concern.

The tax writing committees should have a justifiable pride of authorship in these important tax rules. We look forward to the opportunity to work with you and your staff to further improve them.

Sincerely,

Donald B. Susswein

Enclosure

cc: Senator Lloyd Bentsen
Senator John H. Chafee
James C. Gould
Catherine T. Porter

Technical Appendix

The following technical comments were prepared by Andrew E. Furer, Vice President of Salomon Brothers Inc, Donald B. Susswein, Partner, Thacher Proffitt & Wood, and James M. Peaslee, Partner, Cleary Gottlieb, Steen & Hamilton. Please direct all inquiries to Mr. Susswein at 1140 Connecticut Avenue, N.W., Washington, DC 20036 or (202) 293-2424.

I. Comments on Provisions of Technical Corrections Act

In general, we believe the provisions of the proposed Technical Corrections Act would make helpful corrections to the REMIC provisions. Certain of the proposed changes, however, are problematic. It is difficult to respond to certain of the provisions about which we have concerns without knowing more about the tax policy rationale or perceived abuse underlying the specific proposed change.

Members of the staff of the Joint Tax Committee have graciously agreed to meet with us to explain the purpose and intent of the proposed technical corrections, and we hope that our concerns will be obviated. Due to the press of other legislative concerns, the staff was required to postpone a meeting on these issues scheduled for July 22, 1987. Once the staff is able to reschedule a meeting and we have an opportunity to better understand the proposed technical corrections, we hope to be able to supplement this submission with specific suggestions as to how some of the provisions of the Technical Corrections Act can be tailored more closely to the problems they are intended to address.

For purposes of this submission, however, we would like to highlight several of the more problematic proposals, and to illustrate the difficulties they may create.

1. New Proposed Tax on Post-Startup Contributions to the REMIC

The proposed tax on the contribution of certain amounts to the REMIC after the startup date is an entirely new proposal which, unless its intended scope is clarified, could jeopardize the workability of the REMIC provisions. For example, is it intended that a tax be imposed on payments to the REMIC pursuant to contractual rights held in a qualified reserve fund? Is it intended that reserve funds must be fully funded upon the creation of the REMIC even if the funds are not needed until a subsequent time? Is it intended that a tax be imposed on contribution of funds to a REMIC by holders of residual interests to pay operating costs (such as trustees fees), to pay costs of operating, maintaining or improving foreclosure property pending its distribution or to fund a redemption of regular interests? These and other possible interpretations of this potentially very broad rule threaten the viability of the REMIC provisions. Moreover, as indicated above, there is no indication of the problem or potential abuse to which the proposed tax is directed.

2. New Rules Governing the Formation and Structure of the REMIC

New rules governing the formation of the REMIC are proposed. These include new limitations on the ability to contribute mortgages to a REMIC during the initial three-month assembly period authorized by the current statute, and a new definition of regular interests. This definition, requiring all regular interests to be issued on the startup date could have the effect of disqualifying the REMIC if, for example, certain obligations of the REMIC to reimburse servicer advances, guarantee payments, and the like were characterized as regular interests. Somewhat vague limitations on the ability to substitute mortgages pursuant to "swaps" are proposed the purpose and intent of which are very unclear. In addition, the requirement that mortgages acquired during the initial three-month period be acquired pursuant to a fixed price contract in effect on the startup day poses problems in the event it is necessary to acquire mortgages in the event the seller does not fulfill the contract. Finally, a proposed technical correction modifying the definition of qualified mortgages so as to exclude collateralized mortgage obligations is proposed with retroactive effect. There was no indication in the legislative history that the statutory definition of qualified mortgages contained a technical error on this point. Accordingly, leaving aside the merits of the proposal, it seems inappropriate to impose a retroactive effective date.

II. Comments on Areas Not Addressed In the Technical Corrections Act

1. Simplification and Clarification of Rules Intended to Ensure that REMICs are Passive, Self-Liquidating Entities

We believe the rules designed to ensure that the REMIC is a self-liquidating, passive investment vehicle should generally be conformed to the rules applicable to grantor trusts. For example, the only restriction upon the disposition of a mortgage loan during the life of a grantor trust is that there be no reinvestment of the proceeds of such repurchase, since the IRS has held that the ability of a trustee to sell trust assets does not represent discretionary power to vary the investment or active management. *See* Rev. Rul. 78-149, 1978-1 C.B. 448. *Also see* Rev. Rul. 71-399, 1971-2 C.B. 433 (dealing with substitutions); Rev. Rul. 73-460, 1973-2 C.B. 424 (dealing with loan modifications).

2. Treatment of Interest-Only Certificates As Regular Interests

We would recommend that the definition of regular interests be modified specifically to include interest-only certificates, by allowing regular interests to be issued with a "notional" principal amount. Thus for example, a stream of interest-only payments, based on a fixed or variable rate as applied to an identified principal amount would qualify as a regular interest even though the specified principal amount would not be paid to the holders. Under this approach there would be no rule recharacterizing, in whole or in part, regular interests bearing disproportionately high interest as residual interests. Holders of such regular interests would be appropriately taxed, like holders of all other regular interests, under the original issue discount rules for REMIC regular interests.

3. Excess Inclusion Rules

We believe the excess inclusion rules, and the special wash sale rules applicable to residual interests, are seriously flawed and do not serve their intended purpose.

The excess inclusion rules, as currently drafted, characterize entirely too much taxable income as being in excess of an economic return in circumstances where the real economic return of a residual interest exceeds the assumed economic return provided for in the statute. This has impeded the sale of residual interests to pension plans and foreign investors in circumstances where no tax policy concerns are present. In addition, the rules fail to account properly for circumstances where, on a cumulative basis, a residual interest does not produce taxable income in excess of an economic return, although it may do so in a particular calendar quarter. In addition, the excess inclusion rules do not provide a mechanism for the refund of taxes paid on nonexistent income, once the acceleration of taxable income reverses itself and results in taxable income lower than real economic income.

We would be happy to work with the staff to improve the excess inclusion rules or to develop an alternative approach to address their underlying policy concern. We submitted one suggestion to the staff near the end of last year's tax conference; we have begun to review other approaches which may also be feasible.

4. Treatment of Foreign Holders of Regular and Residual Interests.

We believe it should be clarified that the holders of residual interests are not subject to the 30% withholding tax except on amounts in excess of a reasonable economic return, as determined under appropriately modified excess inclusion rules or some alternative approach. This would conform their treatment to that of equity interests in owner's trusts. In addition, the treatment for estate tax purposes of regular interests held by foreigners should be conformed to that of foreign holders of other debt instruments.

5. Minimum/Maximum Prepayment Guarantees

We understand that Congress intended REMICs to be the exclusive vehicle for issuing multiple class mortgage related securities, after a five year transition period intended to ensure that the REMIC vehicle is "appropriate and serviceable" for this purpose. Under the current statute, and in the absence of clarifying Treasury regulations, it is unclear whether REMICs may provide for the issuance of Regular Interests or Residual Interests that are subject to maximum or minimum prepayment guarantees.

Minimum prepayment guarantees have already become a feature of some well known issues of collateralized mortgage obligations. Substantial research and development efforts are being undertaken to create CMOs with maximum prepayment guarantees. In the absence of statutory or regulatory clarification of the permissibility of these structures under the REMIC rules, the REMIC vehicle will clearly be inappropriate as the exclusive vehicle Congress intended to create.

We would be happy to work with the staff to develop appropriate modifications to the REMIC rules to facilitate minimum and maximum prepayment guarantees.

6. Reserve Funds

We believe a number of statutory clarifications are needed in relation to the REMIC provisions for qualified reserve funds. In the first place, we believe the definition of a reserve fund asset as an asset "held for investment" should be deleted, since it does not describe guarantees and other contracts that are held by the REMIC for permissible reserve fund purposes.

Secondly, we believe it should be clarified that, consistent with the statutory goal of keeping reserve funds as low as possible, it is permissible to add cash (either from mortgage payments or from fresh funds paid to the REMIC) to reserve funds from time to time after the REMIC is formed if that is a reasonable course of action in light of the purposes of the reserve.

In addition, we believe the permissible purposes for reserve funds should be expanded to include reasonable debt service reserves. For example, in the case of a REMIC supported by graduated payment mortgages, it would be desirable to include a cash reserve fund for the purpose of providing regular interest holders with level cash payments that could not be supported by the mortgages themselves in early years. In addition, many mortgage securities provide reserve funds to compensate for a two-month delay in the receipt of payments following acquisition of certain FHLMC (Freddie Mac) mortgage securities.

7. Amortization of Bond Premium

The final specifications for the REMIC provisions expressly provided for premium amortization on REMIC mortgage assets to the same extent that such assets, if acquired at a discount, were to be subject to a mandatory section 1278(b) election. The agreement of the Conferees on this point, as well as many other points, was a critical aspect of the final negotiations with industry representatives on the REMIC provisions. The Technical Corrections Act should ensure that the REMIC provisions incorporate this point.

The REMIC provisions, however, fail to provide special rules allowing for amortization of premium on mortgages. Although the technical corrections provisions of the 1986 Act allow for premium amortization on mortgage loans generally, they do so only with respect to mortgages originated after September 27, 1985. We believe a technical correction is appropriate to allow for amortization of premium on REMIC qualified mortgages without regard to their origination date.

8. Qualified Liquidation Rules

We believe the qualified liquidation rules should be modified to allow the distribution, in lieu of a sale, of the REMICs assets to holders of regular or residual interests in the REMIC. Such a distribution should be a nontaxable event to the REMIC, and the holders of interests should take the property distributed by the REMIC with a substitute basis.

9. Prohibited Transaction Payments

We believe it should be clarified that the payment of a prohibited transaction tax by a party other than the REMIC, or the reimbursement to the REMIC of such a tax, will not itself be a prohibited transaction.

10. Measurement of Qualifying Assets

We believe there is a need for clarification of the time or times at which the percentage of a REMICs assets is tested, for purposes of Code sections 593, 7701,(a)(19) and 856.

In addition, the REMIC provisions do not provide guidance as to which assets of the REMIC are to be included in the ratio for purposes of the 95% test. We recommend that cash flow investments or amounts that represent a receivable from the servicer be characterized in the same manner as the related mortgage for purposes of determining the status of REMIC interests as qualifying assets.

11. Recovery Of Unrealized Loss Or Gain On Contributions

Under section 860F(b)(1)(A), no gain or loss is recognized by the transferor on the transfer of any property to the REMIC; such nonrecognition will be limited to circumstances where such transfer is in exchange for a regular or residual interest in the REMIC under the Technical Corrections Act. The rules under this section provide that, with respect to regular interests, the unrecognized gain is to be included in income pursuant to rules similar to those under section 1276(b), and the unrecognized loss is amortized under rules similar to those under section 171.

Holders of residual interests, however, are required to include the unrecognized gain or amortize such unrecognized loss in income over the "anticipated period during which the real estate mortgage pool (sic) will be in existence." While the reference to "real estate mortgage pool" rather than a "real estate mortgage investment conduit" appears to be a technical oversight from earlier versions of the REMIC legislation, we believe that additional technical corrections to this provision are required.

We believe the technical correction should provide that unrecognized gain or loss in the case of a residual interest should be taken into account over the weighted average life of the residual interest. (The anticipated life of a REMIC may significantly exceed the weighted average life of the residual, merely because there is a relatively insignificant portion of the pool outstanding for a long period of time.) For purposes of this rule, the weighted average life should be determined in a manner consistent with the prepayment and reinvestment income assumptions used in computing original issue discount on regular interests.

12. Information Reporting

REMICs and issuers of interests in REMICs are subject to the information reporting requirements imposed under sections 1275 and 6049 of the Code. Furthermore, the exception to the reporting requirements in section 6049(b)(2), applicable to corporations and certain other entities, is eliminated. In addition, the Secretary is authorized to issue regulations requiring the reporting to holders of residual interests such information as frequently as is necessary or appropriate to permit such holders to compute their taxable income accurately.

The provision of regulatory authority to require more frequent than annual reporting is indicative of the fact that information reporting in the form of the traditional annual Form

1099 may not be a workable or practical approach. In addition to problems that may be posed for fiscal year taxpayers, many corporations may not have facilities or procedures for the collection of information from paper information reports.

Corporations holding publicly issued bonds issued with original issue discount are accustomed to obtaining their income reporting information from the IRS publication relating to OID on such bonds. The creation of an IRS publication for REMIC tax information, in lieu of annual (or more frequent) paper information returns, would be desirable. To the extent statutory changes are needed to implement this goal, we would recommend that the Technical Corrections Act incorporate them. We would be happy to work with the staff, and the staff of the Treasury Department and the IRS, to implement this concept.

13. Cash Flow Investment Rules

We believe modifications to the cash flow investment rules are needed to accommodate reasonable administrative difficulties involved in distributing amounts received shortly before a regular distribution date. In short, some reasonable grace period is necessary. We would be happy to work with the staff to develop appropriate modifications to the REMIC provisions in this area.

14. Taxable Mortgage Pools

We believe the rules governing taxable mortgage pools may prohibit transactions which the Congress did not intend to prohibit. In particular, we do not believe that the Congress intended to limit the ability of corporate issuers of multiple class mortgage backed securities to file a consolidated return with members of their affiliated group. The effect of this rule would be to preclude the "plain vanilla" CMO, billions of dollars of which have been issued with no suggestion that there is a tax policy concern involved in their issuance. Indeed, we understood that the Conferees' intention was not to limit, under the taxable mortgage pool rules, multiple-class securities issued by corporations subject to a two level tax. In addition, the application of these rules to other transactions may have other unintended consequences which we believe should be revisited.

THOMAS JEFFERSON UNIVERSITY

Office of the
Associate Director of Development

Philadelphia, 19107
(215) 928-7990

July 14, 1987

U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

To Whom It May Concern:

I would ask you to encourage an amendment to the Technical Corrections Act preserving IRC §2642(a)(2)(B)(ii)(II). It does not appear to this writer that charitable gift annuities are in commpetition with commercial insurance, and a number of charitable institutions do depend on the charitable gift annuity for gift income, as it is a way (the other being the pooled fund) that a small donor can make a gift similar to the charitable remainder trust gift that can be made by wealthier individuals.

Thank you.

Sincerely yours,

Francis J. McGovern

Francis J. McGovern
Associate Director of Development/
Director of Planned Giving

FJM/gt

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REFER TO FILE# 8728

July 16, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

VIA: FEDERAL EXPRESS

RE: Technical Corrections Bill of 1987 (H.R. 2636); I.R.C. §163(d) Carry-Forward Accounts

Dear Mr. Leonard:

I am writing to you in order to bring to your attention a problem which involves the interaction of I.R.C. §163(d) and §469, as amended or enacted by the Tax Reform Act of 1986, and the previously existing §163(d). Specifically, the interaction of these provisions produces an arbitrary effect on investment interest carry-overs under I.R.C. §163(d), which appears to be wholly unintended. Throughout this letter when we refer to investment interest deductions we are not referring to construction period interest.

I have closely reviewed the investment interest limitation provisions in this regard, and my office has informally contacted staff members of the Joint Committee on Taxation to discuss the intent and scope of these provisions. The question involved is a highly technical one, however, it does have the potential for working an apparently unintended hardship on certain particular taxpayers, including one of my clients. We are therefore contacting the Committee on Ways and Means in the hope of obtaining some relief, because the status of carry-over accounts under the previously existing I.R.C. §163(d) was apparently not considered at the time that major changes were made to this section under the Tax Reform Act.

Section 163(d) previously prevented a taxpayer from deducting interest expenses used to purchase or carry investment assets to the extent that these interest expenses exceeded the sum of "net investment income" (gross investment income minus other investment expenses) plus $10,000. Any interest expenses made non-deductible by this subsection could be carried forward and deducted in the following year, subject to the same limitation of net investment income plus $10,000. Real estate properties subject to a net lease were generally included within the definition of property held for investment.

The Tax Reform Act of 1986 added §469 to the Internal Revenue Code. This section generally prevents a taxpayer from claiming deductions from passive activities to the extent they exceed his positive income from passive activities. Rental activities, including net leased real estate, are included within the definition of a passive activity.

Section 469 has to some extent therefore subsumed §163(d) by applying even stricter limitations on deductions which were previously limited by this other section.

At the same time that Congress added §469, it also amended §163(d). One of these amendments specifies that §163(d) does not apply to any interest which is taken into account under §469 with respect to a passive activity. On the other hand, the scope of §163(d) has been expanded somewhat by including within the definition of property held for investment those assets which yield portfolio income under I.R.C. §469(e).

The changes made by the Tax Reform Act of 1986 raise the question as to whether the interest expense deductions suspended under the old §163(d) and carried forward, which are attributable to real estate investments subject to a net lease, should after 1986 be carried over and used in the computation of the taxpayer's passive loss limitation under §469. The alternative would be to carry this suspense account forward to the new §163(d). The old and the new versions of the investment interest limitation are radically different, though they bear the same numerical section designation. Most notably, interest expenses from net leased real estate were subject to the previous version of §163(d), while they are not subject to the new version of this same section.

Although a carry forward into §469 for real estate interest expenses suspended by the old §163(d) appears logical, and would be entirely compatible with the purposes of the new §163(d) and §469, there appears to be no statutory authority for this proposition. Moreover, such a carry forward is arguably prohibited by the transition rule of §501(c)(2) of the Tax Reform Act of 1986, which bars any part of I.R.C. §469 from applying to losses carried forward from previous years.

In the course of the conversations we have had with some legislative aides on this topic, it was suggested that §501(c)(2) was intended as a relief measure for taxpayers. In this case, however, its effect appears to be quite different.

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The result of the interaction of these various parts of the law is to work a hardship on certain taxpayers, and appears to violate the policy of matching income with expenses, which underlies some of the most important changes made by the Tax Reform Act of 1986.

It has been suggested that the affected taxpayers could still make use of the carry-forward losses by netting them against income from portfolio assets, such as bonds and other interest-producing assets. As a practical matter, however, this provides little or no relief for taxpayers involved in real estate development. The interest carrying expenses are perhaps the most significant of all costs incurred by real estate developers, even above the cost of construction. Although a large portion of these interest expenses were suspended by the old §163(d), these deductions should be allowed against the gain realized on the property when it is sold.

Some taxpayers may never be able to make use of the deductions for interest expenses which were in fact previously paid. Producing sufficient portfolio income to make use of the suspended deductions would require huge amounts of investment capital. This would prove very difficult for those taxpayers whose assets are already devoted to the same real estate activities which produced the interest suspense accounts.

I can appreciate that the members of the Committee are now under substantial pressure to restore the many tax benefits previously enjoyed by real estate activities. I believe that the matter I have raised here is of an entirely different character, in that we are not seeking to use real estate deductions to offset income from other sources, or to shelter cash flow from real estate investments. Instead, we wish to be able to make use

Robert J. Leonard, .sq.
July 16, 1987
Page 5

of suspended deductions for amounts which were in fact previously expended, and only to the extent that the real estate investments yield taxable income either from their current operations or at the time of disposition. As the law presently stands, it appears that deductions from real estate operations which were suspended under the old law, will now be sidetracked into a tax accounting category which has no relation to the investment which originally yielded the suspended deductions.

I would therefore request that a provision be inserted into the Technical Corrections Bill of 1987 to amend §501(c)(2) of the Tax Reform Act of 1986 to provide that any deduction suspended under I.R.C. §163(d) prior to 1987 which was attributable to rental activities which are now subject to I.R.C. §469 should be carried forward into the suspense account created by I.R.C. §469(b). Although there might be some question as to which investment interest expense deductions suspended under the old §163(d) were attributable to rental activities, I believe that sufficient guidance on this point is provided by Temporary Regulation §1.163-8T issued by the I.R.S. earlier this month.

If you have any questions concerning our proposal, or if I may in any manner be of assistance, please do not hesitate to contact me, or my associate, John Pritchard.

Yours very truly,

THOMAS S. CARLES

TSC:cms

cc: Seymour Ebner, CPA
Hon. Frank J. Guarini

WRK228/1001

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July 24, 1987

Laura Wilcox, Esquire
Mary McAuliffe, Esquire
Counsel
Senate Finance Committee
205 Dirksen Senate Office Building
Washington, D.C. 20510

RE: Comments on S. 1350 and Request for Amendment to Subsec. (i) of Sec. 118 of Title I of the Technical Corrections Act of 1987, Concerning Amendments Related to Title XVIII of the Tax Reform Act of 1986

Dear Ms. Wilcox and Ms. McAuliffe:

Enclosed herewith please find six copies of the comments of the Integrated Resources Life Companies concerning S. 1350, the Technical Corrections Act of 1987.

We believe the requested amendment would resolve an ambiguity perpetuated in the Tax Reform Act of 1986. This section could be construed so to result in life insurance contracts using the "age set-ahead" method of substandard underwriting to be excluded from the definition of life insurance as contained in section 7702 of the Internal Revenue Code. We believe the legislative history of the bills reveals that this was not the intent. We therefore request that a Technical Correction be added so that the maturity date of a life insurance contract shall be deemed to be no earlier than the day on which the insured attains insurance age 95, and not later than the day on which the insured attains insurance age 100.

I would be pleased to provide any additional information you may need.

Very truly yours,

Daniel J. Piliero II

Daniel J. Piliero II

REQUEST FOR TECHNICAL CORRECTION TO INSURE THAT THE SUB-STANDARD LIFE INSURANCE POLICIES WRITTEN USING THE AGE SET-AHEAD METHOD ARE NOT TECHNICALLY DISQUALIFIED UNDER THE DEFINITION OF LIFE INSURANCE

SUMMARY

S 1350 represents a well balanced and equitable attempt to correct technical shortcomings in the Tax Reform Act of 1986 ("the Act"). Given the complexity of the Act, it is not surprising that amendments or clarifications would be needed. Many of these have been addressed by S 1350. Some have not. One such needed change concerns the definition of "life insurance" in Sec. 1825 of the Act, and as contained in Sec. 7702(e)(1) of the Internal Revenue Code ("the IRC"). The present definition of life insurance provides, in pertinent part, that "the maturity date [of the insurance contract. . . shall be deemed to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. . ." IRC § 7702(e)(1)(B), as modified by § 1825 of the Tax Reform Act of 1986 (emphasis added).

The underscored words appear to exclude from the definition of life insurance those policies underwritten using the long-recognized "age set-ahead" method to rate substandard insured's. Such policies "adjust" the age of the insured to accurately reflect the insured's mortality risk as measured by industry standards. It is respectfully submitted that neither the Tax Reform Act of 1986 (nor the Technical Corrections Act of 1984) were intended to exclude policies using the age set-ahead method from the definition of life insurance. The intent of the statutes would be fully served by clarification in the Technical Corrections Act of 1987 so that the maturity date of a life insurance contract shall be deemed to be no earlier than the day on which the insured attains <u>insurance</u> <u>age</u> 95, and no later than the day on which the insured attains <u>insurance</u> <u>age</u> 100.

REQUEST FOR TECHNICAL CORRECTION TO INSURE THAT SUB-STANDARD LIFE INSURANCE POLICIES WRITTEN USING THE AGE SET-AHEAD METHOD ARE NOT TECHNICALLY DISQUALIFIED UNDER THE DEFINITION OF LIFE INSURANCE

I. INTRODUCTION

The age set-ahead method of life insurance underwriting is one of the oldest methods of life insurance underwriting. Ambiguities in the Technical Corrections Act of 1984, as perpetuated by the Tax Reform Act of 1986, have cast doubt on its continued validity as an underwriting technique under the defintion of "life insurance" as set forth in Section 7702 of the Internal Revenue Code. For the reasons set forth below, we would urge an addition to HR 2636 to clarify the continued propriety of this well-recognized method of rating substandard insurance risks.

The Integrated Resources Life Companies (hereafter, "Integrated" or "IRLC") believe it is clear that the age set-ahead method of rating life insurance policies was not intended to be proscribed by Internal Revenue Code Section 7702. We review below the problem as we have identified it, together with a brief legislative history of the provisions in issue. Taken together, they support the need for a technical correction to clarify the continued propriety of the age set-ahead method.

II. APPARENT NEED FOR LANGUAGE CLARIFICATION

There are two common ways for a life insurance company to charge for substandard mortality. The more common method is simply to charge an extra premium each year, based on the "table" (the seriousness of the insured's condition) into which the insured falls.

The other method is to charge the insured a premium based on a higher age than his or her actual age. The age chosen by the company is that higher age at which mortality is the same as that which would be expected for a substandard insured. This is the method used by a number of life insurance companies, including Integrated.

The main question concerning the use of the age set-ahead method appears to be ambiguous language in the Deficit Reduction Act of 1984, as perpetuated in the Tax Reform Act of 1986, which requires certain guideline premium limitations to be met in order for a contract to be treated as life insurance. This ambiguity raises potential problems specifically when the age set-ahead is for more than five years. When this occurs, the policy will not reach endowment status between ages 95 and 100, as required by the statute. (For example, a whole life policy issued for an age set-ahead of 10 years matures at insurance age 100 when the insured's actual age is 90). Because the law does not specify that the test can be based on an insurance age that is different than the insured's actual age, the age set-ahead method of calculation falls into a gray area under the statute.

At present, this technicality could nullify one of the oldest methods of rating substandard risks. It is as well a method much simpler for the life insurance consumer to understand -- a main reason for its use. Clarifying language would accordingly be appropriate to allow the continued use of this method.

One concern expressed about the age set-ahead method is that it appeared to be an arrangement to permit an increase in cash value at lower ages that may be advantageous for some taxpayers who would benefit from paying higher premiums, and thereby be provided with a greater amount of tax-free build-up. This raises the "investment orientation" issue -- which in this case is a non-issue. The Exhibits provided herein demonstrate that no such increase in the cash value at lower ages occurs using the ASA methods.

Indeed, our calculations (as set forth in the attached Exhibits) indicate that the accumulated cash value is <u>less</u> for those insureds when the age set-ahead method is used. The Exhibits provided also present a detailed breakdown of substandard life insurance policies using the ASA method for insureds aged 35, 45, and 55. The policies represented in the Exhibits are "no-load" policies, for which mortality information is based on the industry recognized 1980 CSO. The following briefly reviews each Exhibit.

Exhibit I:

The three illustrations that comprise Exhibit I indicate that, for the same amount of gross premium, a step-up in age results in less insurance and a lower rate of return. The taxpayer cannot benefit from paying higher premiums in order to get a greater amount of tax-free build-up. This illustrates that the age set-ahead method is merely a practical approach to place a substandard insured at the proper mortality level. It cannot be used to bypass Section 7702, for it has no inherent investment orientation.

For example, a 35 year old male in the tenth policy year (without age set-ahead) has a policy accumulated value of $18,378 with a death benefit of $100,000. If a step-up in age of ten years is assumed (to age 45) the accumulated value in the tenth year is $17,195, and the death benefit is $61,084. In short, the same premium that purchased $100,000 of coverage for a 35 year old purchases less coverage, and has a lesser accumulated value in the tenth year, for a policyholder age 35 with a step-up in age of ten years. The three charts in Exhibit I consistently follow this pattern.

Exhibit II:

Exhibit II compares the accumulation value, net single premiums, and adjusted death benefit under the cash accumulation tests of Section 7702 for defining life insurance as calculated for a 45 year old applicant considered under the mortality tables and a 45 year old applicant assuming an age set-ahead of nine years (to insurance age 54). The comparison reveals that the use of the ASA method allows, again, for less accumulation value than the accumulation value present not using the ASA method.

For example, using Table D(4), a policy issued to an applicant age 45 would, in a tenth policy year (by which time the insured would have attained age 55) have an accumulated value of $43,910, with a death benefit of $100,336. Using the ASA method to set-ahead the age of the insured nine years to insurance age 54, after the tenth policy year (at which time the insured's policy age would be 64) the accumulated value is $42,444, with a death benefit of $92,847. The figures are obviously quite close.

Exhibit II shows fairly conclusively that the age set-ahead method calculated using recognized mortality figures (1980 CSO) compares favorably with other methods of rating substandard mortality. It produces results that are eminently consistent with the use of a multiple of the standard cost of insurance rates, a method recognized as being acceptable under Section 7702. In sum, the ASA method is a time-tested, reasonable, and valued method for rating substandard mortality, and produces results consistent with other methods recognized as acceptable.

II. THE LEGISLATIVE HISTORY REVEALS AN ATTEMPT TO LIMIT INVESTMENT-ORIENTED POLICIES, NOT A PROSCRIPTION OF THE AGE SET-AHEAD METHOD

Prior to the passage of the Deficit Reduction Act in 1984, the definition of life insurance in the Internal Revenue Code was essentially glossed over by reference in such sections as Section 1035 ("Certain Exchanges of Insurance Policies", see especially Section 1035(b)(3)) and Sections 1817, 1818 ("Treatment of Variable Contracts"; "Other Definitions and Special Rules"). The Deficit Reduction Act set out the Code's first comprehensive definition.

That comprehensive definition (including the computational rules in issue) was enacted, however, to address a major concern of Congress, often expressed, to contain the "proliferation of investment-oriented life insurance policies." (See, H.R. Rep. No. 432, 98th Cong., 2d. Sess. 1445, reprinted in 1984 U.S. Code

Cong. and Ad. News, 698, 1088, (hereinafter "House Report", p. _"). The Blue Book prepared by the Staff of the Joint Committee on Taxation likewise noted that because of this "general concern", the definition of life insurance was "narrowed in some respects." General Explanation Of The Revenue Provisions Of The Deficit Reduction Act Of 1984, Prepared By The Staff Of The Joint Committee On Taxation (December 31, 1984), page 646 (hereinafter "Staff Report", p. ___).

The change adopted in the approach to endowment contracts evidenced the basic rationale for the terms of Section 7702(e). Whereas Section 1035(b)(3) through reference to Section 1035(a)(1) included endowment contracts in the definition of life insurance, the amended definition of life insurance excluded such contracts from the definition of life insurance due to their "innate investment orientation." House Report, p. 1443; Staff Report, p. 647.

The Staff explanation makes this clear in a number of places. For example:

> The [new] rules restrict the actual provisions and benefits that can be offered in a life insurance contract. . . in order to limit the investment orientation of insurance contracts.

Staff Report, p. 651. In short, the use of thinly-veiled investment vehicles ostensibly styled as life insurance contracts was to be remedied by the amended definition of life insurance and the computational rules of Section 7702(e) enacted under the Deficit Reduction Act.

At the same time, express language was added to the Act, and discussed in the Staff Report, to the effect that contracts which adopt age adjustment features may be recognized as appropriate. For example, there are two substantive tests under which a contract may qualify as a life insurance contract: the cash value accumulation test, and the guideline premium and cash value corridor test. The computational rules applicable to both substantive tests state that the maturity date of the contract is "deemed to be" no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

Two of the three exceptions analyzed in the Staff Report are particularly instructive. We believe they resolve any doubts or questions concerning the acceptability of the ASA method. First, it is noted that, concerning a second method of age adjustment -- age set-back for female insureds -- an actual contract maturity date later than age 100 will qualify under the computational rule. More importantly, it is expressly stated that:

> Similarly, a contract written with a termination date before age 95 (e.g., term life insurance to age 65), which otherwise satisfies the requirements of Section 7702, will qualify as a life insurance contract for tax purposes.

Staff Report, p. 652 (emphasis added). In short, not only are contracts using the ASA method quite similar in all respects with the values -- accumulated values and death benefits -- employed in "traditional" contracts, and thus do not represent "innate investment vehicles", but they otherwise satisfy the requirements of Section 7702. Indeed, ASA life insurance contracts are merely an example of an age adjustment method for rating life insurance policies, a method expressly recognized as encompassed within the terms of "life insurance" under Section 7702 as explained by the Staff Report.

The changes in the Tax Reform Act of 1986 concerning § 7702(e)(1)(B) conformed the language of subparagraph (B) with that of subparagraphs (A), (C), and (D), so that the maturity date of a life insurance contract would be "deemed to be" no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. The prior hard-and-fast requirement that the maturity date "will be" no earlier than the date on which the insured attains age 95 and no later than the date the insured attains age 100 thus gave way to a more flexible approach fully in accord with the position that ASA is an appropriate methodology.

For these reasons, we would urge that any remaining ambiguity concerning the ASA method be eliminated through the adition of a Technical Correction recognizing the propriety of ASA policies under the Section 7702 definition of life insurance, by the addition of the following language to subsection (i) of Section 118 of Title I of S. 1350:

(i) AMENDMENT RELATED TO SECTION 1825 OF THE REFORM ACT.-

(1) Paragraph (1) of section 1825(a) of the Reform Act (relating to amendments related to section 221 of the Tax Reform Act of 1984) is amended by striking out "on which the insured attains age 95, and no later than the day on which the insured attains age 100" and inserting in lieu thereof "on which the insured attains insurance age 95, and no later than the day on which the insured attains insurance age 100."

(2) Paragraph (4) of section 1825(a) of the Reform Act (relating to amendments related to section 221 of the Tax Reform Act of 1984) is amended by striking out "Section 7702 (e)(2)" and inserting in lieu thereof "Effective with respect to contracts entered into after October 22, 1986, section 7702(e)(2)."

We would be pleased to respond to any questions concerning the proposed amendment.

Respectfully submitted,

Daniel J. Piliero II

Daniel J. Piliero II
On behalf of the Integrated
Resources Life Companies

Date: July 24, 1987

Exhibits I

ILLUSTRATION FOR AN AGE 35

Gross Annual Premium = $1,378.00
Interest Rate On Accumulation = 9.25%
Cost Of Insurance = 1980 CSO Male, ANB

Definition Of Life Insurance: Cash Value Accumulation Test
Net Single Premiums = 1980 CSO Male, ANB at 6%

Table Of Accumulation Values and Death Benefits

	No Step Up In Age		Age Set Ahead 5 yrs		Age Set Ahead 10 yrs		Age Set Ahead 15 yrs		Age Set Ahead 20 yrs	
Insurance Age At Issue	35		40		45		50		55	
Initial Face Amount	100,000		78,984		61,084		46,720		35,605	
Policy Year	AV	DB	AV	DB	AV	DB	AV	DB	AV	DB
5	7,370	100,000	7,170	78,984	6,934	61,084	6,692	46,720	6,350	35,605
10	18,378	100,000	17,794	78,984	17,195	61,084	16,544	46,720	15,812	35,605
15	34,608	128,120	33,414	101,149	32,114	80,689	30,783	65,170	29,255	53,185
20	57,255	173,325	54,742	137,543	52,116	110,332	49,332	89,683	46,339	73,774
25	87,923	220,915	83,089	175,905	77,932	141,676	72,674	115,702	66,943	95,777
30	128,510	272,062	119,456	217,165	110,190	175,430	100,528	143,828	91,305	119,695
35	180,349	327,865	164,659	262,149	148,370	212,277	133,212	174,633	119,035	146,075
40	244,535	389,317	217,833	311,658	192,909	252,893	170,131	208,778	152,400	174,497
45	319,695	457,396	279,584	366,518	242,918	298,099	214,487	245,587	191,269	191,269
50	406,687	533,144	348,598	427,785	302,932	346,855	265,993	265,993	MATURED	MATURED

Exhibits I (Illustration for Age 35 Continued)

	No Step Up In Age		Age Set Ahead 5 yrs		Age Set Ahead 10 yrs		Age Set Ahead 15 yrs		Age Set Ahead 20 yrs	
Insurance Age At Issue	35		40		45		50		55	
Initial Face Amount	100,000		78,984		61,084		46,720		35,605	
Policy Year	AV	DB	AV	DB	AV	DB	AV	DB	AV	DB
55	503,572	617,963	431,345	493,888	372,438	372,438	MATURED	MATURED		
60	619,657	709,503	526,986	526,986	MATURED	MATURED				
65	753,623	753,623	MATURED	MATURED						
Internal Rate Of Return	5.29%		5.07%		4.84%		4.60%		4.34%	

Exhibits I

ILLUSTRATION FOR AN AGE 45

Gross Annual Premium = $2,240.00
Interest Rate On Accumulation = 9.25%
Cost Of Insurance = 1980 CSO Male, ANB

Definition Of Life Insurance: Cash Value Accumulation Test
Net Single Premiums = 1980 CSO Male, ANB at 6%

Table Of Accumulation Values and Death Benefits

	No Step Up In Age		Age Set Ahead 5 yrs		Age Set Ahead 10 yrs		Age Set Ahead 15 yrs		Age Set Ahead 20 yrs	
Insurance Age At Issue	45		50		55		60		65	
Initial Face Amount	100,000		76,485		58,289		44,585		34,182	
Policy Year	AV	DB	AV	DB	AV	DB	AV	DB	AV	DB
5	11,352	100,000	10,955	76,485	10,396	58,289	9,798	44,585	9,000	34,182
10	28,149	100,000	27,085	76,485	25,887	58,289	24,618	44,585	23,235	34,182
15	52,574	132,095	50,395	106,689	47,894	87,069	45,330	72,168	42,500	60,806
20	85,318	180,624	80,761	146,819	75,861	120,776	70,658	101,092	65,757	86,204
25	127,581	231,936	118,974	189,416	109,593	156,797	100,892	132,263	92,797	113,877
30	180,391	287,194	164,574	235,460	149,475	195,954	135,636	166,447	125,461	143,652
35	242,895	347,516	218,080	285,891	194,872	239,139	177,515	203,253	163,851	163,851
40	315,809	414,008	278,520	341,789	249,494	285,669	226,499	226,499	MATURED	MATURED
45	397,679	488,015	351,136	402,048	313,127	313,127	MATURED	MATURED		
50	495,927	567,833	435,456	435,456	MATURED	MATURED				
55	609,715	609,715	MATURED	MATURED						
Internal Rate Of Return	4.86%		4.63%		4.37%		4.09%		3.78%	

Exhibits I

ILLUSTRATION FOR AN AGE 55

Gross Annual Premium = $3,825.00
Interest Rate On Accumulation = 9.25%
Cost Of Insurance = 1980 CSO Male, ANB

Definition Of Life Insurance: Cash Value Accumulation Test
Net Single Premiums = 1980 CSO Male, ANB at 6%

Table Of Accumulation Values and Death Benefits

	No Step Up In Age		Age Set Ahead 5 yrs		Age Set Ahead 10 yrs		Age Set Ahead 15 yrs		Age Set Ahead 20 yrs	
Insurance Age At Issue	55		60		65		70		75	
Initial Face Amount	100,000		76,490		58,642		45,136		34,571	
Policy Year	AV	DB	AV	DB	AV	DB	AV	DB	AV	DB
5	17,835	100,000	16,810	76,490	15,441	58,642	13,906	45,136	11,853	34,571
10	44,411	100,000	42,235	76,490	39,861	58,642	37,201	47,788	34,599	40,376
15	82,167	149,374	77,768	123,811	72,913	104,318	68,307	89,547	63,916	78,435
20	130,146	207,202	121,220	173,433	112,812	147,890	104,938	128,775	99,457	113,877
25	188,017	269,000	173,090	226,911	159,201	195,365	149,302	170,950	141,755	141,755
30	256,438	336,176	232,697	285,556	215,239	246,447	201,744	201,744	MATURED	MATURED
35	334,321	410,265	304,544	348,701	281,100	281,100	MATURED	MATURED		
40	428,029	490,090	388,581	388,581	MATURED	MATURED				
45	537,198	537,198	MATURED	MATURED						
Internal Rate Of Return	4.39%		4.11%		3.80%		3.43%		2.91%	

Exhibits II

45 Year Old Applicant Table D(4) Substandard Class
Gross Premium for an Issue Age 54 used in each Illustration

		Issue Age 45 200% of 1980 CSO				Insurance Age 54 Age Set Ahead to 54		
Policy Year	Attained Age	Accum Value	NSP 200%	Death Benefit	Attained Age ASA 9 Yrs	Accum Value	NSP 100%	Death Benefi
10	55	43,910	437.63	100,336	64	42,444	457.14	92,847
15	60	80,878	513.25	157,580	69	78,601	534.29	147,113
20	65	128,586	591.94	217,228	74	124,892	612.97	203,749
25	70	187,765	668.87	280,720	79	181,007	685.24	264,151
30	75	258,952	741.41	349,270	84	247,635	751.01	329,736
35	80	340,021	801.26	424,358	89	323,575	804.96	401,976
40	85	431,978	851.72	507,183	94	413,070	859.28	480,716
45	90	532,694	887.54	600,192	99	523,772	943.40	555,196
50	95	646,390	920.91	701,904		----------Matured--------		
55	100	704,887	1000.00	704,887		----------Matured--------		

T.RowePrice
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Henry H Hopkins
Vice President and Legal Counsel

July 17, 1987

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate
Committee on Finance
Room 5D-205
Dirkson Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

The purpose of this letter is to express the concern of T. Rowe Price Associates, Inc. ("Price Associates") regarding certain provisions of H.R. 2636, the Technical Corrections Act of 1987 ("the "Technical Corrections Bill"). If adopted, the Technical Corrections Bill will affect the tax treatment of many regulated investment companies and their shareholders. Briefly stated, this bill would significantly modify the requirement that a regulated investment company derive less than 30% of its gross income from the sale or other disposition of stock or securities held for less than three months. Section 851(b)(3) of the Internal Revenue Code of 1986 (the "Code") currently provides that a regulated investment company must derive less than 30% of its gross income from the sale or other disposition of stock or securities held for less than three months. This test is generally referred to as the "short-short rule". The stated purpose of the short-short rule is to prevent a regulated investment company from actively trading securities for the purpose of making short term trading profits. Despite industry efforts, supported by the Treasury Department, to have the short-short test repealed as part of the 1986 Act, the provision was unfortunately retained. There is currently pending a Bill (H.R. 2295) which would repeal the short-short rule.

The Technical Corrections Bill would substantially amend section 851(b)(3) to expand the types of property that would be covered by the short-short rule to include, among other things, gross income derived from the sale or other disposition of options, futures or forward contracts held for less than three months and, except as may be provided in regulations, foreign currency held for less than three months. If enacted in its current form, the Technical Corrections Bill would apply retroactively to taxable years beginning after October 22, 1986.

The scope of the above-cited provisions is at this time unclear. While the provisions apparently apply to income from the sale or disposition of "foreign currency" held for less than three months, a definition of "foreign currency" is not provided. Section 106(n)(2) of the Technical Corrections Bill appears to apply at a minimum to currency gains realized upon disposing of foreign coin or currency (for example, upon exchanging the foreign coin or currency into U.S. dollars or upon paying expenses with foreign coin, foreign currency denominated debt instruments or accruals of items of expenses or income in foreign currency units). If section 106(n)(2) of the Technical Corrections Bill were interpreted as applying to such transactions, foreign currency gains realized on a settlement date attributable to exchange rate fluctuations between the trade date and the settlement date, or upon the receipt of principal on a foreign currency denominated debt instrument within three months of the instrument's acquisition, (including principal payments on short-term debt instruments having maturities of less than three months) would be counted for purposes of the short-short rule. Similarly, foreign currency gains realized upon receipt of an interest payment on a foreign currency denominated bond, or upon receipt of the redemption price on an instrument bearing original issue discount in foreign currency units, might also result in short-short income to the extent attributable to interest (or foreign currency original issue discount) accrued during the three month period prior to the payment.

Furthermore, because section 106(n)(2) of the Technical Corrections Bill would also apply to the sale or disposition of futures and forward contracts held for less than three months, that provision may also apply to any foreign currency gains realized between the date the agreement was entered into to exchange one currency for another and the settlement date (typically two banking days later). We believe that section 106(n)(2) of the Technical Corrections Bill inappropriately includes for purposes of the short-short rule income wholly unrelated to the purpose of that rule. That provision causes particular concern because it would be applied retroactively. Although regulations may limit the extent to which foreign currency gains will be included for purposes of the short-short rule, it must be assumed that until such regulations are issued the provision will be applied to currency gains arising in a broad range of circumstances.

We believe that it is imperative that section 106(n)(2) of the Technical Corrections Bill be modified to delete the provision relating to foreign currency gains. If such action is not taken, certain investment companies will fail to qualify for Subchapter M treatment. From a tax policy point of view, there is no reason why an investment company should fail to qualify for Subchapter M treatment, and thus be subject to the full corporate level tax, as a result of foreign currency transactions that are ancillary to the investment company's business of investing in securities. This is true because (i) the investment company must buy and sell foreign currency in order to make (and liquidate) investments in foreign currency denominated stocks and securities, and (ii) as the Treasury has previously noted, it is appropriate for an investment company to use currency positions to hedge the currency risks associated with investments in foreign denominated stocks or securities. The ability to utilize such hedges to protect the value of an investment company's portfolio assets, as well as to reduce its exposure to currency fluctuation between the trade date and the settlement date on the purchase or sale of foreign stock and securities, is absolutely essential in light of the dramatic currency fluctuations that can and often do occur over very short periods of time.

We believe that the Treasury's authority to treat currency gains that are not ancillary to an investment company's business of investment in stock or securities as non-qualifying income under section 851(b)(2) is a sufficient "governor" to prevent inappropriate investments or speculation by investment companies in foreign currencies. If such gains are ancillary to the investment company's business of investment in stock or securities, there is no reason to disqualify an investment company from Subchapter M merely because the currency gains are derived in less than three months if such gains are not so ancillary, they properly constitute non-qualifying income under section 851(b)(2) and may subject an investment company to disqualification under that provision.

Currency gains can arise under a variety of circumstances and, because of the nature of investments in foreign stock or securities, often arise during a very short time frame. For example, an investment company may sell a bond denominated in Deutschmarks and place the proceeds in a bank account with the expectation that it will use these funds to purchase another security shortly. A week later, the investment company may use these amounts to purchase another bond denominated in Deutschmarks, or, alternatively, may use the marks to purchase Swiss Francs which in turn will be used to purchase a bond denominated in Swiss Francs. During the week that the investment company is holding the Deutschmarks, they may appreciate significantly vis a vis the U.S. dollar. Surely this "currency gain" should not put the investment company at risk of losing its status under Subchapter M.

There are many other examples which could be cited. Subjecting these gains to section 851(b)(3) or attempting to delineate which types of currency gains must be taken into account for purposes of section 851(b)(3) and which types of currency gains are exempted, would create an impossible situation.

Price Associates cannot emphasize enough the seriousness of this matter and the adverse consequences that would ensue if the Technical Corrections Bill were allowed to pass in its present form. The arbitrary disqualification of legitimate investment companies will, of course, not only adversely impact such companies but also their shareholders.

If Congress determines it is necessary to expand the short-short rule to include certain foreign currency gains, any expansion must be implemented on a prospective basis only. A retroactive application of such a change to taxable years beginning after October 22, 1986 (the date of the enactment of the Code) will result in the disqualification of certain investment companies under Subchapter M without reasonable notice. The Code and its accompanying legislative history contain no indication that section 851(b)(3) would be expanded to cover foreign currency gains. Even the Joint Committee Explanation of the 1986 Act, which was released in May of this year, gives no indication that section 851(b)(3) would be so changed.

We appreciate the opportunity to comment on the Technical Corrections Bill and reiterate that we would be happy to discuss this matter with you at your convenience.

Sincerely,

T. ROWE PRICE ASSOCIATES, INC.

By: ______________________
Henry H. Hopkins
Director and Legal Counsel

HHH:cmd

The Twentieth Century Fund

Talking Paper on Exemption from
Excise Tax on Net Investment Income

Until most operating foundations were exempted by the Tax Reform Act of 1984, all private foundations had to pay a 2 per cent excise tax annually on net investment income. IRC § 4940(a). In the last five fiscal years, the tax liability of The Twentieth Century Fund (the "Fund") under this provision has ranged from \$43,000 to \$218,000.

The thrust of the 1984 legislation was to exempt (1) foundations already classified as operating foundations and (2) new operating foundations which were "publicly supported," in that they received a substantial portion of their support from contributions from the public or from the government. While the Fund receives neither public contributions nor government funds, the Fund had been classified as an operating foundation for many years prior to the 1984 Act. However, the IRS has taken the position that the Fund is not entitled to the tax exemption on the ground that the Fund was not in compliance with the tests for operating foundation status at the point in time the statute looked to in determining whether an existing foundation was classified as an operating foundation. The IRS not only looked to the wrong time under the statute, it also looked to the only time in the Fund's history in which the Fund was not in compliance with the tests. In any other individual year and on a cumulative basis, the Fund satisfied the tests by a wide margin; indeed, the Fund has operated as a paradigmatic example of the way Congress wanted operating foundations to function. Because the IRS has reached a result which is not only grossly inequitable and could have consequences to the Fund on a cumulative present value basis of as much as a million dollars, but is contrary to the intent of Congress, the Fund seeks a technical correction to the 1984 Reform Act. The details follow.

I. Imposition of Excise Tax on Net Investment Income

As a private foundation, the Twentieth Century Fund (the "Fund") is required to pay a 2% excise tax annually on its net investment income. This excise tax is imposed by Section 4940(a) of the Internal Revenue Code (the "Code").

II. Statutory Exemption from the Excise Tax

A. Section 302 of the Tax Reform Act of 1984 added Section 4940(d) to the Code to provide an exemption from the excise tax for "exempt operating foundations."

B. In order to qualify as an "exempt operating foundation," the following requirements contained in Section 4940(d)(2) of the Code must be satisfied:

1. The foundation must be an "operating foundation" (i.e., generally must distribute at least 85% of its income directly in the active conduct of its exempt purpose).

2. The foundation must be "publicly supported" (i.e., generally must receive a substantial portion of its support from governmental units or from contributions made by the general public) for at least 10 years prior to the year in which exempt operating status is claimed.

3. The governing body of the foundation (in the Fund's case, the trustees) must be composed of individuals at least 75% of whom are not "disqualified individuals" (generally, individuals who are substantial contributors to the foundation who are related to a substantial contributor).

4. The governing body of the foundation must be broadly representative of the general public in the sense of representing a broad cross-section of the views and interests of the general public.

5. No officer of the foundation may be a disqualified individual.

C. Section 302(c)(3) of the 1984 Tax Reform Act, which is technically an effective date provision and does not appear in the Code itself, provides that a foundation will be treated as satisfying the "publicly supported" requirement if the foundation was an operating foundation as of January 1, 1983.

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The Fund received a determination letter from the IRS dated February 14, 1972 which confirmed the Fund's tax-exempt status (originally granted in 1937) and classified the Fund as an operating foundation under the private foundation regime introduced into the Code by the 1969 Tax Reform Act. The 1972 determination letter has never been revoked, and there have been no changes in the purpose, character or method of operation of the Fund, based upon which the determination letter was granted.

D. In order to qualify for the exemption a foundation is required to request a ruling from the Internal Revenue Service recognizing its status as an exempt operating foundation.

III. <u>The Fund's Request for a Ruling</u>

A. By letter dated June 30, 1986, the Fund requested a ruling that it qualified as an exempt operating foundation entitled to the excise tax exemption. The request was thereafter supplemented by additional financial information requested by the IRS.

B. In a telephone conversation on February 13, 1987 with the Fund's attorneys, the IRS advised that it was prepared to deny the requested ruling on the ground that, despite its 1972 determination letter, the Fund did not meet the technical requirements for operating foundation status for its fiscal year ended June 30, 1983 (which included the operative January 1, 1983 date).

1. The technical requirements to which the IRS referred are contained in Treasury Regulations promulgated under Section 4942(j)(3) of the Code (which defines the term "operating foundation"). A foundation's status for a particular taxable year is not determined solely by whether it meets the definition of an operating foundation (see above) for the year in question but by reference to the foundation's activities over a four-year period which includes the year in question and the three preceding years. Over this four-year period, the foundation must satisfy the 85% income distribution requirement either in three of four years or by totalling the figures for the four years and applying the test to these aggregate amounts.

2. Because of an unusual set of circumstances, which are described in IV below, the Fund in fact did not meet the regulatory requirements for the 1983 fiscal year. This was the <u>only</u> year for which the Fund has failed to satisfy these requirements. Upon satisfying the regulatory test for its 1984 fiscal year, the Fund's operating status was automatically restored under the Treasury Regulations.

3. Rather than officially denying the requested ruling immediately, the IRS provided the Fund's attorneys with an opportunity to reply to the IRS' position and to present any arguments in the Fund's favor.

IV. The Fund's Reply to the IRS Position

A. In a letter to the IRS dated March 3, 1987, the Fund made the following technical and equitable arguments in support of its request for an exemption from the excise tax.

1. From a technical standpoint, it was argued that the IRS' use of fiscal years 1980 thorugh 1983 as the relevant four-year test period was erroneous, and that, using the proper test period (1979 through 1982), the Fund qualifies for the exemption. This argument is based on what the Fund believes is the proper interpretation of the operative language, which requires that a foundation have been an operating foundation as of January 1, 1983 in order to qualify for exemption. The Fund argued that the underscored phrase evidences a Congressional intent to determine the exemption by reference to the foundation's status as of the end of the most recently completed period, which in the case of a calendar year foundation would be the year ended December 31, 1982. In the case of the Fund, the most recently completed period was the fiscal year ended June 30, 1982. By contrast, the IRS' interpretation requires that events occurring after January 1, 1983 date be taken into account in determining whether the exemption is available, and it seems unlikely that Congress intended this result. In fact, the use of a January 1 date clearly suggests otherwise.

2. From an equitable standpoint, it was argued that the Fund is a classic example of the type of organization intended to be relieved of the excise tax burden. Over the 17-year period since the 1969 Tax Reform Act first imposed statutory distribution requirements on private foundations, the Fund has distributed an aggregate of $6.7 million more than it was required to distribute. Furthermore, although the Fund in fact did not satisfy the operating foundation test for the 1983 fiscal year, this was the only year in which this occurred and was caused by abberational market conditions which greatly increased the Fund's income. Because of the nature of its program (which requires substantial lead time before expenditures are made), the Fund simply was unable to make timely additional distributions reflecting the surge in income. The Fund believes that it would be inequitable and contrary to the intended purpose of the legislation if it were denied the exemption under these circumstances.

V. <u>Present Status of IRS Ruling Request</u>

After reviewing the Fund's technical and equitable arguments in support of the request for exemption, the IRS orally advised the Fund's attorneys that, while it disagreed with the Fund's arguments, it would submit the request to the IRS Chief Counsel's office for further consideration, with a recommendation that the exemption be denied. The Fund's attorneys were advised that this review process could be expected to take six months or longer. Thus, no decision can be expected until at least September.

VI. Legislative Solution to the Problem

A. Based on the arguments set forth above, the provision in question would appear to be a particularly well-suited subject for amendment in the Technical Corrections Bill which is currently being drafted in Congress.

1. The provision is ambiguous and subject to conflicting interpretations, and the IRS' literal reading would arguably defeat the intent of Congress in this particular case.

2. Even assuming that the IRS' interpretation is correct, this reading produces an unintentionally harsh result in the Fund's case, given the policy intended to be served by the provision, and this result can be easily avoided by corrective legislation.

3. The amendment of this provision would be of negligible revenue consequence (since it is highly unlikely that anyone but the Fund would be benefitted) and could be drafted in a way that would not adversely affect any other organization.

TEDDY KELLER
63 PLAZA DE LA NOCHE NE
ALBUQUERQUE, NM 87109
(505) 821-5074

September 4, 1987

Laura Wilcox, Hearing Clerk
Senate Finance Committee
SDOB 205
Washington, D.C. 20510

Dear Ms. Wilcox:

You're probably aware that one of America's vital and most notable resources is its writers. You may not have realized that we are an endangered species. The Senate Finance Committee and the IRS are combining to drive us to extinction. We've no idea why we're being singled out for destruction, but we ain't going without a fight

As you've guessed, I'm a freelance writer. Author of stories and books and plays and articles. And I'm soon to be a bellyaching taxpayer.

Currently I'm a beleaguered writer. Or I will be when the new tax laws are enacted. I hope you've heard from zillions of writers on the subject. Because a lot of us may soon cease to be writers. TRA-86 has become our new cuss word.

For starters, elimination of home-office deductions is, by itself, disastrous. Most writers work at home. How many other professional people are not allowed to deduct office expenses?

Other idiocies in the new law include: * We can no longer deduct expenses on unsold material. (Good grief. Most of us work on speculation. Personally, I rack up all manner of expenses, never knowing for sure that anything will sell or when.) * All expenses and deductions must be allocated or prorated to the projects I'm working on. (Impossible. Research on a recent trip to Kansas, for instance, may wind up in a novel, a play, a short story, an article or any number of writing projects over the next several years. Or it may never be profitably used.) * And we're supposed to "estimate the life of the earning power" of any and all manuscripts. (Impossible. I have one play which earns me $7.50 in royalties every six months. Another, in print for years, earns a respectable amount of money. One of my unsold novels may eventually earn me a thousand dollars, and it could earn a hundred times that. Many of my short stories have been published and forgotten. Others have been reprinted and picked up for anthologies and purchased for TV, and have generated lives and income far beyond anybody's early expectations.)

There is Technical Corrections Bill S1350. It does propose to amend TRA-86. However, writers hereabouts understand that Committee Chairman Baucus--or his staff--range from rude to hostile when approached on the subject of changing the offending--and offesive--bill.

Whose idea was this in the first place? Writers have never been favored by the IRS, and we certainly don't deserve such discriminatory tax treatment. If we are to be driven out of business, then Congress should prepare some suitable alternative. I suppose I could become a politician, but there must still be honorable ways to make a living.

Yes, I'd hate to move permanently to Ireland to avoid unjust taxation, and, no, I don't think I'd get away with cheating on my tax return. Since that makes me a stay-at-home chicken, I've gotta find help somewhere.

Sincerely, Teddy Keller

Statement of Texas Air Corporation

On

S.1350, The Technical Corrections Act of 1987

Technical Corrections Act of 1987
Source of Income from Leased Transitional Aircraft

We would like to call your attention to a technical problem in the Tax Reform Act of 1986 that was not corrected in the proposed Technical Corrections Act of 1987, S.1350. The problem is caused by the inadvertent termination with respect to transitional aircraft of the prior-law rules for sourcing income from leased aircraft.

I. The Problem

Section 204(c)(3)(A) of the Tax Reform Act of 1986 provided that certain commercial passenger aircraft with respect to which a binding contract was entered into before April 1, 1986 need not be placed in service before 1990 in order to qualify as transitional property under sections 203(b)(1) and 203(b)(3) and thereby continue to qualify for the investment tax credit ("ITC") and for depreciation deductions under the prior-law accelerated cost recovery system ("ACRS"). Due to a technical oversight, an amendment to the foreign tax provisions may have the effect of denying the intended transitional relief to a substantial number of these aircraft.

This problem arises because the Tax Reform Act (1) repealed Internal Revenue Code ("IRC") section 861(e), which treated income from U.S.-manufactured aircraft leased to U.S. persons as income from U.S. sources regardless of where the aircraft was flown, and (2) amended section 863(c)(2)(B), which also treated as from U.S. sources income from aircraft leased to U.S. persons and flown to or from the U.S. Under the new law, all or part of the income from such aircraft is considered as from foreign sources.

In the early years of an aircraft lease, the deductions attributable to the aircraft will exceed the rental income from the lease. The recharacterization of such deductions and income as foreign-source will cause a reduction in the portion of the lessor's income that is treated as from foreign sources. This reduction in foreign-source income will necessarily reduce the lessor's ability to credit taxes paid to foreign countries against U.S. income tax because the fraction used for calculating the amount of foreign taxes available to offset U.S. taxes becomes smaller as foreign income becomes a smaller percentage of the taxpayer's total income.

As a consequence of the changes in the sourcing of income from leased aircraft and the effect of such changes on the foreign tax credit limitation, much of the benefit of transitional relief for commercial passenger aircraft will be unavailable to owners who lease such aircraft to U.S. airlines with international routes. The financial consequences of this loss of tax benefits to the aircraft owner are borne by the U.S. airlines rather than by the lessors. Tax indemnity provisions in aircraft leases pass the cost of increased taxes of the lessor through to the lessee of the aircraft in the form of increased rents.

Although it is appropriate that Congress should determine the source of the income and deductions from aircraft leased to U.S. persons, the rules should not have been changed in the case of transitional craft. The transition rules should consistently and fairly apply to the financing techniques available for the air carrier when it entered into the binding contract to acquire the aircraft. Many carriers contracted to buy airplanes based on their ability to finance the purchase with a leveraged lease. In the case of a leasing transaction, ~~the~~ lessor considers not only the ITC and the depreciation but all the tax attributes of the transaction. The resourcing of the income eliminates many lessors, that were available under prior law when the contract was signed. Overseas air carriers will be generally restricted to using regulated utilities as lessors. With the reduced competition in the leveraged lease market, the cost of leasing aircraft will increase. For pre-existing, non-grandfathered leases, the tax indemnity clause will be triggered and the cost of leasing retroactively increased.

We do not believe that Congress, when it changed the sourcing rules, intended to eliminate transitional relief from the repeal of ITC and the changes to ACRS. The sourcing rules, like the availability of ITC and prior-law ACRS, were an important consideration in decisions to enter into binding contracts with aircraft manufacturers. The very same considerations of equity that led Congress to provide transitional relief with respect to ITC and ACRS require that the same relief be extended with respect to the sourcing rules.

II. Solution

Section 861(e) and 863(c)(2)(B) (prior to the 1986 amendment) should continue to apply to aircraft entitled to transitional ACRS and ITC relief.

III. Proposed Correction

Section 1212(f)(2) of the Tax Reform Act of 1986 should be corrected by deleting the period at the end thereof and adding the words "or attributable to property described in Section 203(b)(1) or 203(b)(3) and in Section 204(c)(3)".

We would appreciate your addressing this issue. If you have any questions concerning our description of the problem or our proposed solution, I encourage you to contact either Donald C. Alexander (862-2336) or William T. Brack (659-0702), both of whom are familiar with this matter.

# # # # #

TOM S. KING
Executive Vice President

TEXAS SAVINGS & LOAN LEAGUE • 408 W. 14TH ST. • AUSTIN, TEXAS 78701 • 512/476-6131

July 16, 1987

Mr. William J. Wilkins
Chief Counsel
Senate Finance Committee
205 Senate Dirksen Office Building
Washington, D.C. 20510-6200

Dear Mr. Wilkins:

Enclosed please find a copy of the submission from the California League of Savings Institutions to the Committee on Ways and Means.

The Texas Savings and Loan League, representing our 280 member associations, strongly support the issues addressed and urges your assistance in including these necessary items in H.R. 2636 and S. 1350 (Technical Corrections Act of 1987) in their final form as they are submitted to the House and Senate for approval.

Should you or any member of your staff have questions regarding this matter, please do not hesitate to contact me.

Sincerely,

Tom S. King

Tom S. King
President

Mr. Robert J. Leonard
Chief Counsel
Committee on Ways and Means
Longworth Home Office Building
Room 1102
Washington, D.C. 20515

Re: (1) H.R. 2636 and S. 1350 (Technical Corrections Act of 1987);
(2) Joint Committee on Taxation, Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means (JCS-17-87, June 25, 1987

Dear Mr. Leonard:

In accordance with Policy Release #12 of the Committee on Ways and Means (June 10, 1987), the California League of Insured Savings Institutions, which represents 215 member organizations, hereby submits its comments with respect to the above-captioned matters:

1. Technical Corrections Act

A. Modification of "at risk" provisions relating to sales of foreclosed real estate ("REO") by savings and loan associations. (Code Section 465.)

The Tax Reform Act of 1986 ("1986 TRA") changed the tax consequences of holding real property acquired through the use of non-recourse financing. If a savings and loan provides financing for the sale of its own REO on a non-recourse basis, the purchaser's tax basis in the property is now restricted by the "at risk" rules. If, however, a third party institution regularly engaged in the lending business finances the purchase on a "commercially reasonable" non-recourse basis, the purchaser escapes such tax basis restrictions. It has become apparent, however, that while the new rules have minimal revenue impact, they inhibit normal lending practices and jeopardize the process of an orderly and systematic disposition of foreclosed properties by thrifts. These new rules are particularly prejudicial to savings and loans operating in 10 states (such as California), where state law prohibits lenders from making recourse loans with respect to sale or their own foreclosed properties.

We believe that historically savings and loans have financed more than 80% of the sales of their own REO. Because of the new law, however, potential purchasers will be unwilling to accept seller financing and will seek to arrange financing from third party lending institutions. In many, if not most of such situations, such alternative financing will simply be unavailable because of a lending institution's inherent unwillingness to finance "a competitor's problem" i.e., previously foreclosed and unfamiliar property with an uncertain valuation, held by another financial institution. The ramifications of this hindrance are obvious and unnecessary in light of the fact that numerous other restrictions affecting real estate introduced by the 1986 TRA are more than sufficient to satisfy any reasonable perception of potential tax abuse. The most pressing dilemma faced by troubled thrifts and the Federal Savings and Loan Insurance Corporation is the disposition of REO. Congress should seek to eliminate, rather than impose, obstacles to the disposition of such troubled properties, particularly since the 1986 TRA negated most of the tax benefits formerly associated with the acquisition of rental real estate and thrust such property into a relatively tax disfavored tax position in terms of investment alternatives.

It is the position of the California League that the "commercially reasonable" exception and its rationale are similarly applicable to a situation where a savings and loan is financing sales of its own REO to unrelated third parties; that the failure to include such exception in the 1986 Tax Reform Act should properly be viewed as an oversight; and that the Technical Corrections Act of 1987 should provide appropriate relief for REO sold by savings and loans.

B. <u>Modification of 1987 effective tax rate applicable to savings and loan associations</u>.

It is the firm view of the California League that due to legislative oversight in connection with the enactment of the 1986 Tax Reform Act, many savings and loans are currently faced with an anomalous and unreasonable effective tax rate regarding their 1987 tax year.

The legislative history of the 1986 TRA reflects a fundamental, ongoing commitment by both the Administration and Congress to the proposition that as a corollary to the overall increase in the post-1986 corporate taxable base, post-1986 tax rates would not be increased. In this regard the "percentage of taxable income" bad debt reserve method, which is unique to the savings and loan industry, has since its inception in 1951 been treated by Congress as a tax rate concession linked to and conditioned upon an institution's commitment to the primary activity of providing home financing.

The 1986 TRA reduced the general calendar year corporate tax rate from 46% in 1986 to 40% in 1987. The 1986 TRA provided for an additional corporate rate decrease in 1988 and thereafter, but the 1987 "blended" rate is totally consistent with the overriding corporate tax rate precept applied by the 1986 TRA, namely that post-1986 corporate tax rates would thereafter not exceed the 1986 corporate tax rate.

Due to the complexities attendant to the drafting of the 1986 TRA, the reduction provided for the percentage of tax income bad debt reserve deduction inadvertently violates this principle during 1987. As a consequence, the savings and loan business is in a unique and untenable position, viz: the tax rate applicable to calendar year savings and loans (after taking into account the IRC § 593 percentage of taxable income bad debt deduction) actually increases from 31.28% in 1986 to 36.8% in 1987. After 1987, the tax rate applicable to calendar year associations reverts to 31.28%. Accordingly, while other calendar year corporations are enjoying a 15% decrease in their corporate rate during 1987, calendar year savings and loans are incurring more than an 18% increase in their tax rate in 1987.

This is clearly neither the intended result nor a fair result. The legislative history establishes a clear pattern of lowering the 1986 tax rate for non-savings and loan corporations by increments in 1987 and thereafter, while retaining the 1986 tax rate for savings and loans. There is no valid policy reason to justify the anomaly of a one year tax increase applicable to a single industry. Accordingly, the Technical Corrections Act of 1987 should contain an appropriate amendment to the 1987 percentage of taxable income bad debt reserve method allowance which will assure that the tax rate applicable to savings and loans with regard to their 1987 taxable years shall in no event exceed the pre-1987 and post-1987 rate of 31.28%.

2. Joint Committee on Taxation, "Description of Possible Options To Increase Revenues Prepared For The Committee on Ways and Means" (JCS-17-87), June 25, 1987.

A. Tax Treatment of Recoveries of Bad Debt of Thrift Institutions, p. 160.

This portion of the Option Pamphlet analyzes the possibility of a proposed amendment (hereinafter "proposal") to the applicable law (Section 595) which would require that all amounts in excess of basis realized by a savings and loan on the sale of its foreclosed property ("REO"), be treated as taxable income, rather than being added to the institution's reserves for bad debts.

It is the position of the California League that the proposal should unequivocably be rejected for the following reasons:

(i) The analysis is misleading in terms of the current status of its cited case law precedent. Gibraltar Financial Corporation of California v. United States, 86-1 U.S.T.C. par. 9405 (Ct. Cl. 1986) (hereinafter "Gibraltar") is a lower, trial court decision. The case has been appealed by the Government to the United States Court of Appeals for the Federal Circuit (No. 86-1578), and thus the holding of the lower court remains in doubt. On the other hand, the only Federal Circuit appellate court which has dealt with the issue of gain realized on the sale of REO by a savings and loan, the Ninth Circuit, has rendered a holding which is in direct conflict with the holding in the Gibraltar case. (First Charter Financial Corp. v. United States, 669 F.2d 1342 (1982).

(ii) The analysis misstates the issue presented in Gibraltar, and proposes a major statutory alteration of Section 595 which would be far broader than the proposition argued by the IRS in that case.

In Gibraltar, the IRS argued, based on Rev. Rul. 75-251, that gain realized on the sale of REO by a savings and loan is taxable under Section 595, but only to the extent that a cash basis taxpayer had previously failed to recognize in its taxable income the uncollected interest which had accrued on the foreclosed note prior to the date of foreclosure. The IRS has never argued that the balance of the gain, or any portion of that balance, should not be credited to the Section 595 bad debt reserves. Accordingly, the proposal, which would prevent all gain on REO from being treated as a reserve credit is far broader and harsher than the position advocated by the Government in

Gibraltar. It represents a total change in the operation of Section 595, rather than, as implied in the analysis, a mere "clarification" of the issue in the Gibraltar case as applied to the existing provisions of Section 595.

(iii) The analysis misstates the operation of the relevant Section 593(b)(2)(B), which section expressly precludes the potential for the "tax exempt gain" referred to in said analysis.

The key rationale of the proposal is the conclusion that "[S]ince the addition to the reserve for bad debts under the . . . [percentage of taxable income bad debt method] . . . generally is computed by reference to the taxable income of the thrift institution, the size of the reserve does not affect the amount of the bad debt deduction for additions to the reserve." The Option Pamphlet further concludes that, because of this purported operational quirk in Section 593(b)(2), Gibraltar ". . . effectively would exempt gain on the sale of foreclosed property from taxation for thrift institutions using the percentage of taxable income method for computing the addition to the reserve for bad debts."

The example provided in the proposal goes on to state that while sales proceeds are added to the bad debt reserves, ". . . the dollar amount of the reserve does not affect the bad debt deduction of the thrift institution if it used the percentage of taxable income method." Finally, the Option Proposal necessarily implicates this so-called "exemption" of gain as the core reason for the proposal, by negatively contrasting the aforesaid purported operation of the percentage of taxable income method with the alternative experience method, where bad debt reserve addition ". . . would reduce the amount of deduction permitted for additions to the reserve. . . ."

savings and loans with regard to expenses incurred in connection with the acquisition, holding and disposition of REO.

In *Allstate Sav. & Loan Ass'n. v. Commissioner*, 68 T.C. 310 (1977), aff'd. 600 F.2d (9th Cir. 1979), *cert. denied*, 445 U.S. 966 (1980) the United States Tax Court held that savings and loans subject to Code Section 593 could not deduct from income expenses incurred in connection with REO, even though *but for* Code Section 595 such expenses would otherwise be fully deductible, because "the most reasonable interpretation of . . . [§595] is that *all* the tax results of foreclosures, including the expenses of disposing of the . . . property, *are to be accounted for through adjustments to the Association's reserve for losses* . . ." (*Allstate*, *supra*, 68 T.C. at 317.) (Emphasis supplied).

Section 595 currently provides a balanced tax approach to REO held by savings and loans, by treating REO sales receipts as "reserve credits" rather than items of income, and REO expenses as "reserve charges" rather than items of expense. The proposal breaks that equation by treating sales receipts as a currently taxable non-reserve transaction, and accordingly should in fairness allow savings and loans to account for their expenses referable to the acquisition, holding and disposition of REO as currently deductible non-reserve transactions.

In plain terms, the analysis is wrong. Section 593 provides not one but *two* limitations on the overall limits or "cap" amounts which can be added to an association's bad debt reserves under the percentage of taxable income method. (Sections 593(b)(1)(B)(ii) and 593(b)(2)(C).) Both limitations have been in the Code since the adoption of the percentage of taxable income method in 1962. The latter provision reads as follows:

> (C) OVERALL LIMITATION ON PARAGRAPH -- the amount determined under this paragraph shall not exceed the amount necessary to increase the balance at the close of the taxable year of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

Accordingly, it is beyond dispute that credits to the bad debt reserve attributable to the sale of REO can affect and reduce the amounts otherwise allowable as bad debt reserve deductions under the percentage of taxable income method. Further, there is no logical reason why the 6% overall bad debt reserve allowance expressly provided by Section 595 should not be achieved by the combined use of bad debt reserve deductions (i.e., reserve "credits") and credits referable to gain on the sale of REO.

(iv) The analysis fails to take into account revenue reducing amendments which should properly be added to Section 595 if the proposal is adopted, in order to provide tax parity to

(v) The proposal runs counter to the origin and purpose of Section 595. Prior to the enactment of Section 595, gains on the sale of REO were not accounted for through credits to the bad debt reserves. The Committee Report accompanying the enactment of Section 595 states that this caused "erratic" tax results which Congress sought to avoid, and that this would be accomplished, in the case of a reserve basis taxpayer, by charging gains or losses on the sale against the bad debt reserves. (S. Rep. No. 1881, 87th Cong., 2d Sess. (1962) at 47-48.) See also H. Rep. No. 1447, 87th Cong., 2d Sess. (1962) at 36-37. The entire thrust of Section 595 is to utilize the Section 593 bad debt reserves as the means of dealing with the tax treatment of the foreclosure itself and all post-foreclosure events, including sales of the REO. In other words, the reserve charges and credits currently provided by Section 595 constitute an integral accounting system, and displacing a major aspect of that system should not be considered in a vacuum, but only as a part of an overall review of all aspects of Section 595.

Very truly yours,

United Methodist Homes for the Aging of the Wyoming Conference

"We care about the people we care for."

THE HILLTOP CAMPUS
HILLTOP RETIREMENT CENTER
JAMES G. JOHNSTON NURSING HOME
GRAND CARE CENTER
285 Deyo Hill Road
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THE WESLEY VILLAGE
MYERS MANOR
PARTRIDGE TIPPETT NURSING FACILITY
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THE METHODIST MANOR
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GRACE VIEW MANOR
80 Calvary Drive
Norwich, NY 13815
Phone: 607 336-3915

July 13, 1987

Ms. Laura Wilcox
US Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I am writing the Technical Corrections Bill (S.1350). It is my hope and the hope of many middle income donors and their favorite charities that Charitable Gift Annuities may be exempted from IRC Section 501(m).

As you may know, Charitable Gift Annuities have been in existence and used by charitable organizations for over 100 years. For the small donor, a Charitable Gift Annuity is the equivalent of a large donor's Charitable Remainder Annuity Trust. Incidentally, these Charitable Remainder Annuity Trusts are unaffected by Section 501(m). Certainly, Charitable Gift Annuities issued by Section 501(c)(3) organizations are not "commercial type annuities".

I might also add for your consideration, that there are three life income gift vehicles which are currently sanctioned by the laws of this nation; Pooled Income Funds, Charitable Remainder Trusts, and Charitable Gift Annuities. All three of these vehicles are designed for making donations to charities. One of the three life income vehicles should not be inadvertently legislated out of existence. It is disturbing that, after 100 years of use, Congress would declare that routine use of this standard fundraising vehicle would cause either the charity's loss of exemption or taxability.

Further, there is a difference between an individual transferring money to Blue Cross/Blue Shield [named in the legislative reports as one of the targets of 501(m)] and an individual transferring funds to a recognized charity. The difference is donative intent; the transferrer does not intend to donate money to Blue Cross/Blue Shield but, in fact buys an insurance policy. The donor to a recognized charity has the donative intent but an incapacity to part with both principal and income, and for that reason elects to establish a Charitable Gift Annuity.

Further, the Code already includes a detailed test for taxing Charitable Gift Annuities that resemble too closely those annuities offered by commercial agencies. Under Section 5014(c)(5) the unrelated business income tax may apply to a Charitable Gift Annuity that fails certain standards. These detailed tests serve the same function as Section 501(m).

I hope that the information presented above may help you and the Committee in considering this issue. I would be delighted to testify in person regarding this matter.

Please let me know if there is any thing else I can do to help the Committee decide this issue. Thank you for your thoughtful attention to this matter.

Very truly yours,

David Fanning

David Fanning,
Director of Institutional Advancement

DF/mem

Today's Tax-Wise
"Gift of Tomorrow"

July 6, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

A bombshell masquerading as a "technical" change in the Technical Corrections Act would, if enacted, discourage the creation of many charitable lead trusts. (Typically a charitable lead trust makes payments to charity for a number of years, with the remainder going to grandchildren.)

I am writing today to ask you to keep the charitable deduction for charitable lead trusts in the generation-skipping transfer tax's (GSTT) "inclusion ration" formula.

Repealing the GSTT charitable deduction for lead trusts is clearly substantive, and not technical. I want to remind you of President Reagan's pledge "not to support any substantive changes to the 1986 Act couched in the form of purportedly technical amendments."

In addition to being substantive, the change is contrary to congressional policy of encouraging charitable gifts. Charitable lead trusts facitilated $45,000 in funding for our human services programs in this county, just last year alone!

I think it's bad policy to discourage an important, long-standing source of support for charitable institutions!

Please oppose this amendment, and keep the charitable deduction in computing GSTT on lead trusts created after June 10, 1987. Preserve IRC Sec. 2642 (a)(2)(B)(ii)(II). Thank you!

Sincerely,

Sally C. Walker

Sally C. Walker
Director, Endowment/Planned Gifts Program

cc: Mary McAuliffe (5 copies)

SCW:np

United Way Endowment/Planned Giving Program
320 East Gutierrez Street, Santa Barbara, CA 93101-1707, Telephone (805) 965-8591

Statement on Technical Corrections S. 1350
IRC Section 501(m)
by Richard D. Bailey, Executive Director
The United Methodist Foundation
in Western North Carolina

Summary

Neither the Joint Committee's Blue Book explanation of the Tax Reform Act of 1986 or the proposed Technical Correction Act (S. 1350) clarified that charitable gift annuities are not subject to IRC Sec. 501(m). Charitable gift annuities are not commercial-type insurance and a technical correction should be made to exempt gift annuities from IRC Sec. 501(m).

Rationale

Section 501(m) of the 1986 Tax Act says that an organization shall be exempt from taxation only if "no substantial part of its activities consists of providing commercial-type insurance." And, "For purposes of this subsection, the issuance of annuity contracts shall be treated as providing insurance." For organizations that do not lose their exemptions and provide commercial type insurance, the activity will be treated as an unrelated trade or business and taxes on these activities as a life insurance company.

Charitable gift annuities are not commercial-type insurance, and it is clear that the drafters of the subsection did not intend to include them. However, since this question has been raised, a cloud has come over the thousands of charitable institutions that issue gift annuities, among them the Salvation Army and American Bible Society. The Bible Society was the first to issue a gift annuity in 1843, and since then has issued 67,383.

This cloud must be lifted from our charities as quickly as possible. Section 501(m)(3) lists four exemptions. The fifth, "(E) charitable gift annuitie could be added. Or, 501(m)(4) could be amended by inserting the words, "other than charitable gift annuity contracts". It would read:

> (4) Insurance Includes Annuities.--For purpose of this subsection, other than charitable gift annuity contracts, the issuance of annuity contracts shall be treated as providing insurance.

Gift annuities do not compete with commercial annuities and are not "commercial-type insurance". For a small donor, they are equivalent of a large donor's charitable remainder annuity trust, which is not affected by IRC Sec. 501(m).

Please amend S. 1350 and clearly exempt the charitable gift annuity from IRC Sec. 501(m).

July 15, 1987

Testimony On Behalf Of

University Patents, Inc.

On

The Technical Corrections Act of 1987, S. 1350

Submitted By F. David Lake, Jr.

July 17, 1987

This written testimony is submitted in response to press release G-3 of the Committee on Finance soliciting testimony on the Technical Corrections Act of 1987, S. 1350.

University Patents, Inc. proposes that Congress repeal section 1605(c) of the Tax Reform Act of 1986 or amend it in technical respects as outlined below in order to correct a continuing and, we believe, unintended abuse created by that section.

Background

Technology transfer organizations are companies that assist universities in marketing the products of research they have sponsored. University Patents, Inc. is a small for-profit technology transfer organization located in Westport, Connecticut. It has subsidiaries in Largo, Florida and Urbana, Illinois. University Patents' principal competitors are Research Corporation of Tucson, Arizona, which is organized as a private foundation, and a newly-formed company to which Research Corporation has transferred its technology transfer business (the "technology transfer organization").

Enactment of Section 1605(c)

During conference on the Tax Reform Act of 1986, Research Corporation succeeded in having a provision added to the bill, section 1605(c). This provision allows it to fund a new company which operates as a taxable nonprofit corporation, without being subject to any of the private foundation regulatory taxes that would otherwise apply under the Internal Revenue Code. The provision was not in either the House or the Senate bill and received little or no scrutiny before being added to the Tax Reform Act. It is not a transition rule, as it does not relate to any other provision of the Act, but is a substantive provision applicable to a single company.

Consequences of Section 1605(c)

Section 1605(c) of the Tax Reform Act of 1986 permitted Research Corporation, a private foundation, to transfer its technology transfer business and investment assets, net receivables, and cash not exceeding $35 million to a new taxable nonstock entity for "debt." The transfer was exempted from the private foundation regulatory excise taxes that are designed to safeguard against this type of potentially abusive transaction. Those taxes include the tax against self dealing which normally would prevent a loan of this nature (certainly any loan at a below market rate of interest), the tax on taxable expenditures which normally would prohibit the transfer of assets to an organization that is not exempt and, most importantly, section 507(c) of the IRC which normally would prevent assets being removed from private foundation "solution" without the repayment of tax benefits obtained while the organization was exempt.

The provision in effect allowed Research Corporation to set up a "non-private private foundation" (somewhat analogous to a nonbank bank) -- an organization that is funded with untaxed private foundation dollars yet is beyond the reach of the private foundation regulations. The new entity has a significant competitive advantage over its taxpaying competitors because its multimillion dollar "core capital" was built up without the payment of any income tax. In addition, since the new taxable entity is a nonstock corporation, it does not have to pay dividends like a normal corporation and the "interest" it pays on the so-called debt gives it a deduction for a dividend equivalent. This result does violence to the private foundation and unrelated business taxable income provisions of the Internal Revenue Code.

Possible Solutions

There are two possible solutions to correct the ongoing abuse caused by section 1605(c). One of the solutions should be incorporated in the Technical Corrections Act of 1987.

First, section 1605(c) should simply be repealed and the assets of the newly-formed corporation should be required to be returned to Research Corporation where the activities of the technology transfer business once again would be subject to the private foundation regulations and any investment income again would be subject to the 2 percent tax on net investment income under section 4940 of the Internal Revenue Code.

Second, in the absence of repeal, the following technical amendments should be made in an attempt to mitigate the continuing unfairness:

1. The first technical correction would define the term "debt" for purposes of section 1605(c)(2)(A) by requiring that any debt obligation pay interest at least annually at the "applicable federal rate" (as defined in section 7872(f) of the Code) and amortize the principal in substantially level payments (not less frequently than quarterly) over the life of the obligation. It is inconsistent with debt status for the obligation to bear interest at less than a market rate and to be repaid in a balloon payment (which could be rolled over into another long-term obligation) at the end of a long maturity period. It also is inconsistent with the private foundation rules for the transferor private foundation to receive less than a market rate of interest.

2. The second technical correction seeks to cure the potential Clay Brown abuse (a taxable entity sheltering its income with deductible payments that are not taxable income to the recipient exempt organization) by providing that interest paid or payable by the technology transfer organization would not be deductible. This provides a measure of equity with taxpaying competitors which pay nondeductible dividends by, in effect, treating payments by the technology transfer organization to the private foundation as nondeductible constructive dividends. Moreover, the technical correction provides some compensation for the unfair advantage of the technology transfer organization receiving a transfer of a startup fund from an exempt organization that is several times the size it would have been if income taxes had been imposed in accordance with the Code.

3. The third technical change would require the private foundation to treat the interest received as unrelated business taxable income. The circumstances of the creation of the technology transfer corporation as the mirror image of the private foundation indicate that it is de facto a controlled corporation. Moreover, Washington Research Foundation, 50 TCM 1457 (1985), holds that the carrying on of a technology transfer business has a substantial commercial purpose and hence is an unrelated trade or business if carried on by an exempt organization. Thus, the technical amendment would amend section 512(b)(13) of the Code to provide that the technology transfer organization is treated as a controlled organization and the ratio of interest treated as UBTI is 100 percent.

STATEMENT OF

UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS

ON THE

TECHNICAL CORRECTIONS ACT OF 1987

(H.R. 2636 and S.1350)

The U.S. League of Savings Institutions* welcomes this opportunity to publicly comment on a number of important tax issues which arose following passage of the historic Tax Reform Act of 1986. This landmark legislative revision of our individual and corporate tax laws was so comprehensive that numerous errors, mistakes and unintended consequences were understandably included in the final law. The list of errors also encompasses a number of savings institution problems. Each of these will be briefly described below followed by the reasons the savings institution business believes that including these changes in the 1986 tax reform legislation was either an oversight or a mistake and should be corrected by this Technical Corrections Act of 1987.

I. "At Risk" Rules

The 1986 Tax Act extended the "at risk" loss limitation rules to deductions resulting from the holding of real property acquired with nonrecourse financing. The "at risk" rules limit the tax benefits derived from real property investment to the investor's equity or the amount for which the investor is personally liable. An exemption was provided for nonrecourse loans secured by real property where the borrowing is from a "qualified person" (defined as "any person who is actively and regularly engaged in the business of lending money"). Thus, a qualified person would include a savings and loan or savings bank regulated under federal or state law. However, despite the qualified person definitional exception, purchasers of foreclosed real estate from depository institutions which also provide financing for the purchase remain exposed to the "at risk" restrictions.

The rules were extended to real property in the 1986 legislation to prohibit taxpayers from artificially inflating the asset's basis and thereby increasing its depreciation and capital gains tax benefits. Prior law encouraged such tax schemes through its generous accelerated cost recovery periods, particularly for real estate, and a 60 percent capital gains exemption.

The 1986 Tax Reform Act corrected this underlying rationale for "at risk" limitations by repealing the favorable ACRS depreciation schedules as well as the capital gains exclusion. Under the new 1986 rules, the cost of residential real property must be recovered no earlier than 27.5 years with most other real property recovered over 31.5 years, using the straight-line method. Additionally, the 1984 Deficit Reduction Act adopted the imputed

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* The U.S. League of Savings Institutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: Joe C. Morris, Chairman, Emporia, Kansas; Theo H. Pitt, Vice Chairman, Rocky Mount, North Carolina; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; Coley C. O'Brien, Senior Vice President and Legislative Counsel; Brian Smith, Senior Vice President, Regulatory Operations. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone (202) 637-8900.

interest rules (Section 1274) which effectively eliminated the below market interest rate as another favorite seller financing tool. All these recent tax law changes have made it virtually impossible to inflate a seller's basis and achieve unjustified tax savings. If the potential for tax law abuse has been eliminated, then why is it necessary to apply the restrictive "at risk" rules to real estate?

The U.S. League strongly believes that the specific application of the "at risk" limitations to purchaser-borrowers of foreclosed property from regulated institutional seller-financiers is a more serious mistake and will cost thrifts far more in carrying costs and disposition expense than it could ever produce in tax revenue. In addition, thrifts are substantially limited by law, regulation and public policy to real estate financing and, therefore, the "at risk" rules are particularly harsh on these institutions. Historically, thrift institutions finance more than 80 percent of their own foreclosed properties. They do not wish to be property owners, especially owners of foreclosed property. However, by expanding the "at risk" rules to seller-financiers, it will make this situation almost unavoidable. In addition, these new "at risk" rules will be particularly prejudicial to savings and loans operating in ten states where state law prohibits lenders from making recourse loans with respect to sales of their own foreclosed properties.

The expanding "at risk" rules will also greatly aggravate the many existing difficulties already involved in disposing of foreclosed property by requiring potential purchasers to arrange financing from other lenders unfamiliar with the property. In most situations, alternative financing will be unavailable because of the nature of the underlying real estate. This result occurs in spite of the fact that the lender in most of these cases was the original qualified third party lender who became a seller-financier only because of circumstances beyond his control. Is this the kind of abusive activity that necessitates extending the restrictive "at risk" rules even to foreclosed property?

The 1986 Tax Reform Act extended the "at risk" limitations to seller financing by a qualified person while at the same time exempting nonrecourse real estate financing by a party related to the purchaser provided the financing from the related person is "commercially reasonable" and on substantially the same terms as loans involving unrelated persons. The U.S. League urges this Committee to provide a similar "commercially reasonable" exception for nonrecourse real estate financing of repossessed property by a thrift provided the following requirements are met:

1. The interest rate charged on the loan is not less than the Applicable Federal Rate (AFR).

2. The amount of the loan does not exceed the thrift's adjusted basis in the property, unless facts and circumstances warrant a higher loan value.

3. If the loan exceeds the adjusted basis, and facts and circumstances do not warrant a higher limit, the excess amount of the loan would be subject to the "at risk" limitation.

II. <u>1987 Tax Rate Spike for Thrifts</u>

The statutory language adopted in the revision of the Section 593 thrift bad debt deduction interacts in an adverse and unforeseen way with the drop in the overall corporate tax rate. The reduction in the corporate rate from 46% to 34% is accomplished over two years with a 40% rate for calendar year taxpayers for 1987 and a blended rate for fiscal basis taxpayers (a taxpayer with an October 1 to September 30 tax year would have a 43% rate for its fiscal 1987 which began on October 1, 1986).

The adjustment to the allowable percentage-of-income thrift bad debt deduction from, in effect, 32% to 8% was carefully calibrated with the 34% corporate tax rate to ensure that the overall federal corporate tax rate for savings institutions remained exactly the same at 31.28% before and after tax reform.

Unfortunately, since the staggered drop in the general corporate rate to 34% is not coordinated with the January 1987 decline in the thrift bad debt percentage from 32% to 8%, calendar year savings institutions face a significant increase in their tax rate for 1987 alone: the rate is 36.8% for this one year, more than 5% higher than the 31.28% rate in effect prior to 1987 and from 1988 onwards.

The general goal of the corporate tax reform effort was to promote straightforward business operations and to reward such activities with lower rates. To impose a higher tax rate on most thrifts in 1987 is at odds with this goal and is clearly unfair and unintended. The problem can be simply corrected by providing that, for calendar year taxpayers eligible for Section 593 bad debt provisions, the 1987 percentage-of-income deduction shall be 21.8% rather than 8% as under current law. The 1987 federal tax rate would thereby remain steady at 31.28% for these institutions.

The revenue impact of this provision as estimated by the Joint Tax Committee staff is, we understand, negligible.

III. <u>NOL Extension Denied to 1982 Fiscal Year Thrifts</u>

The 1986 Tax Reform Act provided thrift institutions an additional three years of net operating loss carryforward benefit for NOLs incurred in taxable years beginning after December 31, 1981 and before January 1, 1986. This effective date wording unfortunately denies most of the eight-year NOL carryforward benefit to those thrifts that operate on a fiscal year basis. There are a substantial number of fiscal year thrifts that begin their taxable years before December 31, 1981 and, consequently, would lose a substantial portion (depending on their fiscal year start - October 1, 1981; July 1, 1981; April 1, 1981) of their NOL carryforward benefit for 1982 tax losses. For example, as a result of this effective date language, an October 1 fiscal year thrift would appear to be prohibited from carrying its losses from the first nine months of 1982 forward for eight years.

The intent of this NOL carryforward provision was to provide all thrifts, not just calendar year thrifts, with three additional years to carry forward the operating losses of this period. There is no justifiable reason for denying the statutory NOL extension to fiscal year thrifts and we ask that the Technical Corrections legislation resolve this discrepancy in wording by allowing fiscal year thrifts to utilize the extended eight-year NOL carryforward benefit for all NOLs sustained in 1982.

IV. <u>The 20 Percent Deposit Continuity Test for NOL Carryovers</u>

Under prior law (Sec. 382(b)(2)(A)), NOLs were fully preserved in a supervisory case where the acquired thrift's deposits comprised at least 20 percent of the total deposits of the acquiring institution. When the acquired thrift's deposits fell below this 20 percent continuity test, its NOLs were not lost but merely reduced or scaled down by 5 percent for each one percentage point below this 20 percent of transferred deposits threshold (Sec. 382(b)(2)(B)).

The newly-enacted Section 382(l)(5)(F) retains the former 20 percent deposit continuity test but omits the important scaledown formula when transferred deposits are less than 20 percent of total combined deposits of the acquirer. It, in effect, establishes a threshold test of 20 percent of deposit continuity with no NOL benefit scaledown when the ratio falls below 20 percent. As a result, when 20 percent deposit continuity is not maintained, the remaining NOLs become subject to the more restrictive 382 limitations. Since in most thrift supervisory cases the financially troubled thrift's value will be zero or less, no NOL carryover benefit will be available to an acquiring thrift when the deposit continuity is less than 20 percent.

This result does not appear to be the intention of either the tax writing committees or their conferees. On the contrary, the policy decision of Congress, as enunciated in the Conference Report on the Tax Reform Act of 1986, Volume II, page 193, was clearly to preserve FSLIC provisions unchanged through the end of 1988. Nevertheless, this 20 percent threshold test change was included in the statute. Indeed, this statutory change makes it more difficult to accomplish the very type of acquisition which FSLIC is attempting to encourage, namely, that large, healthy thrifts rescue smaller troubled institutions. The carryover of NOLs is an important feature in consummating this type of troubled thrift acquisition. Thus, the prior law scaledown procedure should be retained as an incentive for large thrift acquisitions of smaller troubled institutions. Loss of this procedure will exacerbate the problems already faced by FSLIC in handling the financially troubled thrift situation.

For all the foregoing reasons, the U.S. League urges Congress to restore the 20 percent deposit continuity test scaledown formula of former law (Sec. 382(b)(2)(B)) which appears to have been inadvertently eliminated from the new Sec. 382 statutory language.

V. "Firm Commitment" Underwriting

The U.S. League greatly appreciates the fine work of the Ways and Means and Joint Tax Committee staffs on the "firm commitment" problem by including the corrective language on this problem in the recently introduced Technical Corrections legislation (H.R. 2636 and S. 1350). A firm commitment underwriting, in connection with a public offering of stock in a converting mutual savings and loan association, is protected against reduction in NOL carryovers under the two-year "window" for thrift public offerings during 1987-88 (Sec. 106(d)(15) - Technical Corrections bill).

VI. FSLIC-Created "Interim Associations" Should Not Extinguish NOLs

An analogous situation to the firm commitment problem has recently been identified under the 1986 Tax Reform Act. A second reorganization occurring within two years after a first reorganization extinguishes NOL carryovers in toto for years following the second reorganization (Sec. 382(1)(5)(D)). This provision will potentially wipe out NOL carryovers in a FSLIC-supervised acquisition of an insolvent thrift where the thrift's assets are first conveyed to an "interim savings institution" created and operated by FSLIC while a buyer is sought, and then a buyer acquires control of the interim association.

Under prior law, this two-step procedure would not have affected NOL carryovers. In keeping with Congress' clearly stated policy, which is to maintain prior law through 1988, these two parts of a supervisory acquisition should not disallow important-tax attributes. The U.S. League requests that the Technical Corrections legislation provide an exemption from the two-year rule for FSLIC-created "interim associations."

NON-TECHNICAL CHANGES

Reorganization of Financially Troubled Thrift Institutions

Present law provides special rules through December 31, 1988 which exempt the acquisition of financially troubled thrift institutions from rules otherwise applicable to acquisitions, mergers and the receipt of direct FSLIC financial assistance. These provisions, enacted in the Economic Recovery Tax Act of 1981, relax certain requirements for qualification as a tax-free bankruptcy reorganization under the Code. Thus, the requirements that (1) the acquired corporation undergo formal receivership or similar proceedings, and (2) the shareholders and creditors of the acquired corporation receive stock in the acquiring corporation, need not be met (Sec. 368(a)(3)(D)). Although no formal receivership or similar proceeding is required, certain certifications regarding the financial condition of the thrift institution must be received from the Federal Home Loan Bank Board.

In addition, the 1981 Act provisions relaxed the rules regarding the survival of net operating loss carryovers following a merger (Sec. 382(b)(7)), as discussed earlier, and exempted from income and basis adjustment certain payments from FSLIC to the troubled thrift (Sec. 597).

These important tax rules, enacted to broaden the assistance available from the insurance fund, were extended for only two additional years by the Tax Reform Act of 1986. If these provisions were to sunset, as now scheduled on December 31, 1988, the ability of FSLIC to adequately meet its troubled thrift caseload would be seriously impaired. Therefore, some additional extension of these favorable FSLIC tax rules must be considered if the industry is to have the resources necessary to resolve its troubled thrift caseload.

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July 17, 1987

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Technical Corrections Act of 1987

Dear Mr. Leonard:

Enclosed herewith are two statements submitted on behalf of the Texas Housing Agency to comment upon the proposed Technical Corrections Act of 1987.

One statement discusses a problem created by legislative history references to potential limitations on periods during which proceeds of tax-exempt mortgage bonds for single-family housing can be used to originate mortgage loans. These references pose a serious problem inasmuch as neither prior law, existing law, nor the Technical Corrections Bill afford any statutory basis for such limitations.

The second statement discusses proposed clarifications and changes of the placed-in-service limitations relating to the low-income housing credit provided by section 42 of the 1986 Code. The clarifications and changes are proposed in the context of a program under consideration by the Texas Housing Agency under which it would sell single-family homes (acquired by the Agency as a result of homeowners' default on mortgage loans made by the Agency under its tax-exempt single-family mortgage revenue bond program) for use as low-income rental units. As an incentive to purchasers to acquire and so use such units, the Agency wishes to make the credit available.

We appreciate the opportunity provided by the Committee to comment upon this legislation.

Very truly yours,

Charles L. Almond

M E M O R A N D U M

July 17, 1987

Origination of Mortgage Loans with Proceeds of Tax-Exempt Single Family Mortgage Revenue Bonds -- Page 244 of the Description of the Technical Corrections Act of 1987 (H.R. 2636 and S.1350) Prepared by the Staff of the Joint Committee on Taxation

The Board of the Texas Housing Agency (the "THA") has under consideration a proposed bond issue to refund certain of its outstanding single-family mortgage revenue bonds ("SFMRBs"). This refunding would permit THA to make additional mortgage loans funded from amounts that represent prepayments of mortgage loans that were funded with proceeds of the prior issues being refunded.

Refunding bonds are necessary to accomplish this result because the carrying costs (i.e., interest costs of the prior issue) of the pool of prepayment funds would not permit a below-market mortgage rate. However, the reduced interest rate of the refunding bonds will reduce the carrying costs so as to permit the origination of mortgages at a below-market rate.

The THA is concerned about a sentence that appears on page 244 of the Description of the Technical Corrections Act of 1987 prepared by the Staff of the Joint Committee on Taxation. That sentence states as follows:

> As was stated in the legislative history accompanying the Act for refundings occurring before January 1, 1988, refundings permitted under this expansion of the transition exception [i.e., 1988 refundings] may not involve an extension of the period for providing financing for homebuyers.

The statement in the legislative history of the 1986 Act to which the above-quoted sentence is apparently referring is a sentence on page II-716 of the Conference Committee Report accompanying the 1986 Act which states as follows:

> The conferees intends that, as under present law, the period allowed to provide financing for qualified mortgagors in the case of these current refunding bonds [i.e., single-family mortgage revenue bonds], be determined from the date of issue of the refunded bonds (the original bonds in the case of a series of refundings), rather than a new period commencing on the date of the refunding (emphasis added).

This statement in the legislative history has generated some confusion recently.

On the one hand, practitioners have interpreted this sentence in the Conference Committee Report to refer to rules governing temporary periods (i.e., periods during which proceeds can be invested at unrestricted yields pending their use for their intended purpose). These temporary period rules clearly do carry over into existing law. Under those rules, refundings do not extend temporary periods beyond the periods which were otherwise available to proceeds of the prior issue being refunded. The quoted sentence was interpreted simply to confirm the continuation of that rule. That was the only interpretation under which any meaning could be given to the "present law" reference in the Conference Committee Report sentence quoted above.

On the other hand, Hill staff have recently indicated that this sentence was, in fact, intended to refer to a limit on the period during which proceeds of a SFMRB can be used to originate mortgage loans, separate and apart from temporary period rules. However, it is believed that Hill staff will acknowledge that there is no prior law basis for a restriction on origination periods, and there is no statutory basis in the 1986 Reform Act or the Technical Corrections Bill for such a restriction. Therefore, Hill staff have suggested that it may be necessary to amend the statutory language of the pending Technical Corrections Bill if this sentence is to have any clear legal significance.

If debate is had in the Congressional tax-writing committees whether the 1986 Code should be amended to impose a limit on the period during which proceeds of SFMRBs can be used to originate mortgage loans, THA has a number of points that it wishes to make.

1. <u>There is No Apparent Policy Logic that would Support Limitations on Origination Periods.</u>

   A. <u>A limitation on origination periods for SFMRBs is not necessary to curb issue size</u>. Between 1980 and August, 1986, SFMRBs were subject to an annual statewide volume cap equal to 9% of the average annual amount of mortgages originated in the State during the preceding three years (with a $200,000,000 floor for smaller states). <u>See</u> section 103A(g)(4) of the 1954 Code. By virtue of being tied to historical annual demand for mortgage money, this ceiling served the purpose not only of limiting volume in an absolute sense, but also limited the extent to which issuers could size bond issues relative to projected annual demand (particularly in the case of statewide issuers such as THA). Under the 1986 Code SFMRBs are subject to the "unified" state volume cap rules. Although the unified volume cap has no explicit mortgage demand criterion, the difficult allocation choices among different purposes forced upon a state by the admittedly stringent volume limit will also operate to prevent issue sizes in excess of expected near-term demand.

B. A limitation on origination periods for SFMRB proceeds would deprive issuers of the flexibility necessary to ensure maximum realization of the intended benefit of their programs. The intended benefit of tax-exempt SFMRB programs, from both a federal and local government perspective, has been to provide a limited incentive for home ownership by making available below-market interest rates on mortgage loans. The principal factor which causes delays in origination (and thus affects the length of the origination period for SFMRB proceeds) is post-issuance market downturns in mortgage rates -- a factor over which an issuer has no control.

Rates on mortgages originated under SFMRB programs generally must be fixed at the time of bond issuance in order to assure sufficient revenues to repay bonds and to assure compliance with applicable arbitrage requirements. 1/ If subsequent to the establishment of the mortgage rate, a general downturn in interest rates starts to push the conventional mortgage rate down to or below the SFMRB rate, all or some part of the intended benefit of the program disappears until such time as the carrying costs of the unoriginated or prepaid funds can be reduced to reflect current tax-exempt rates. The only means of accomplishing the reduction in bond rates is by refunding an amount of bonds equivalent to the amount of unoriginated funds.

For the last several years mortgage rates in the United States have been on a generally downward trend. Therefore, SFMRB issuers have found it necessary to undertake refund-

1/ A very few SFMRB programs have provided for bonds that can be remarketed during the origination period at then-current rates. However, the legal and administrative complexities of such transactions have made them all but unworkable.

ings in order to provide intended beneficiaries of their program with the intended benefit. 2/

2. Treasury Regulations governing SFMRBs have always specifically authorized a SFMRB program to originate (with no time limitation) new mortgage loans from funds representing prepayments of previously originated mortgage loans.

Treas. Reg. §1.103A-2(i)(3)(ii)(A) grants a "temporary period" for unrestricted investment to:

> Proceeds (including prepayments of principal designated to be used to acquire additional mortgages) of the issue invested for an additional temporary period not to exceed 1 year . . . (emphasis added).

For the same reasons discussed above relating to interest rate trends and the fixed-rate nature of SFMRB programs, the relending of funds representing prepayments must, in many instances, be preceded by a refunding in order to be viable.

3. The limitation on maturities which is a condition to the applicability of the refunding transition rule of section 1313(a) operates as a practical limitation on origination periods.

Under that rule, refunding bond maturities may not extend beyond 32 years from the date the original bond was issued. Therefore, at some point a SFMRB program which reduces carrying costs through refundings would also have to reduce the term of mortgage loans below a term which would be attractive to homebuyers.

CONCLUSION

For the foregoing reasons, THA believes it is neither necessary nor advisable to adopt rules which limit the periods during which mortgages can be originated from SFMRB programs with original or prepayment proceeds.

If for some reason it is determined that such rules are necessary, it would not be fair to apply it to outstanding bonds that have funded

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2/ The application of State ceiling rules to refundings designed to lower the carrying cost of proceeds that had not been used to finance mortgage loans was the subject of two letter rulings. In LTR 8434092 the Service ruled that such a refunding would count against the State ceiling in the year in which the refunding bonds were issued. Subsequent to that ruling, there were colloquies on the floor of the House of Representatives and the floor of the Senate, and subsequent to those colloquies the Service reversed its position in LTR 8540090 and ruled that refundings relate back to the refunded bonds with no new state ceiling consequences. A large number of refundings have been undertaken with legal opinions based on the same reasoning contained in the second ruling.

SFMRB programs (or to refundings of such outstanding bonds) inasmuch as those bonds were issued with the expectation of continued flexibility under existing law (unchanged from prior law) relating to origination periods and refundings to reduce carrying costs. That flexibility should not be retroactively denied.

Supplemental Information

This statement is submitted by Charles L. Almond and Michael A. Jungman of VINSON & ELKINS, 1455 Pennsylvania, N.W., Washington, D.C., 20004-1007, telephone number (202) 639-6500, on behalf of the TEXAS HOUSING AGENCY.

LOW-INCOME HOUSING CREDIT
Technical Correction
[Act § 252; Code § 42(d)]

Background

The Tax Reform Act of 1986 ("Act") provides a new credit to be claimed by owners of residential rental property used for low-income housing, in order to encourage developers to provide additional low-income rental housing and to prevent deterioration of old low-income housing. A 70 percent present value credit is provided for new buildings and a 30 percent present value credit is provided for existing buildings. A building is a new building if the original use of the building begins with the taxpayer applying to receive the low-income housing credit. In the case of existing buildings, no low-income housing credit is available unless (i) the building was acquired by purchase and (ii) at least 10 years has elapsed between the date the building was last placed in service (or the date of the most recent substantial improvement) and the date of acquisition by the taxpayer. (The technical corrections bill presently provides that placement in service by a governmental unit or in certain instances where the property was acquired through foreclosure can be ignored in making this determination).

Under the Act, each state's housing credit ceiling is to be allocated to owners of qualifying low-income housing projects by the housing credit agency of the state (although housing agencies of local governmental units within the state may be entitled to allocate a portion of the credit). The Texas Housing Agency ("THA") is such a state housing agency and is entitled to allocate the credit among owners of low-income housing within the state of Texas.

THA has acquired a substantial number of single-family homes by foreclosure upon the default of mortgage loans THA made through the mortgage revenue bond program. A condition of THA's mortgage loans was that the homes could only be used for owner-occupied residential housing. At present THA still owns most of these homes, which are largely unoccupied.

THA is considering marketing the single-family homes it has acquired through the mortgage revenue bond program to developers. As an incentive to developers to purchase the homes, THA would like to sell them with the condition that they be rented to qualifying low-income tenants and allocate low-income housing credits to those homes. All of the homes that THA would like to sell were acquired by the purchasers to whom THA made mortgage loans within the last ten years. Some of the homes were new at the time the purchasers acquired them, while others were purchased on the resale market. Therefore some, but not all, of the houses are more than ten years old.

If the purchase of the homes and occupancy of homes by THA's borrowers causes the homes to be treated as having been placed in service and the homes cannot otherwise qualify as new buildings, then the homes will be ineligible for the low-income housing credit, because all the homes were purchased by THA's borrowers within the last ten years.

Proposed Technical Correction

(1) Clarify that single-family homes (whether or not more than ten years old) will not be treated as ever having been placed in service for purposes of qualifying for the low-income credit in cases where such homes are acquired by a governmental

unit from the owner-occupant as a result of the owner-occupant's default on a mortgage loan.

(2) Provide that such single-family housing which has always been owner-occupied, and therefore has never been placed in service for the purpose of producing income, will qualify for the credit available to owners of new buildings, because the original use of the building as low-income rental housing begins with the taxpayer seeking the low-income housing credit.

Rationale

The primary purpose of providing a low-income housing credit is to increase the availability of low-income housing by providing incentives to developers to build such housing. However, unless the placed-in-service requirement excludes the purchase of buildings solely for use as owner-occupied housing, a substantial opportunity to increase the availability of housing for low-income individuals will be lost.

It also follows that such homes should be treated as new buildings for purposes of the low-income housing credit if, under this rule, they are treated as never having been placed in service. Treatment as a new building will maximize the intended incentive to developers to provide more low-income housing than is presently available. Making the credit available in the case of housing that has never been used for the production of income would not permit any taxpayers who obtained tax benefits from the incentives available under prior law to take advantage of the credit unless they met present-law requirements.

Supplemental Information

This statement is submitted by Charles L. Almond, Michael A. Jungman and Debra J. Duncan of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of the TEXAS HOUSING AGENCY.

UNIVERSITY OF FLORIDA FOUNDATION, INC.
P.O. BOX 14425
GAINESVILLE, FLORIDA 32604
(904) 392-1691

June 30, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance
S. D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I am writing to express my concern to you and to the Senate Finance Committee over the proposed substantive change which would be brought about by the proposed Technical Correction Act of 1987. Specifically, the Technical Correction Act of 1987 will completely eliminate the charitable deduction in computing the generation-skipping transfer tax on charitable lead trusts created after June 10, 1987. The Act would in effect strike out IRC Secs. 2641 and 2642(a)(2).

The charitable lead trust is and has been an important source of income for many charitable organizations, including the University of Florida. To significantly alter the charitable lead trust by repealing the charitable deduction as an offset against the generation-skipping tax would deny our institution a valuable source of endowment funding for academic enrichment programs and scholarship support for needy and meritorious students.

This change when added to the sunsetting of the non-itemizers' charitable deduction, the addition of appreciation as an Alternative Minimum Tax preference item, and the proposed change in the treatment of charitable gift annuities under IRC Sec. 501(m), will seriously harm the body of charitable organizations. Over a period of time the action of these changes will severely weaken our ability to serve the needs of our students and the individuals of this state and nation who rely upon the teaching and research generated by the University of Florida.

Sincerely,

Robert R. Lindgren
Director of University
Development

RRL/DDO/jak

U.S. CHAMBER OF COMMERCE

Mr. William Wilkins
Chief Counsel
Senate Finance Committee
U.S. Senate
205 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Wilkins:

The Chamber of Commerce of the United States respectfully submits the following comments on S.1350, the Technical Corrections Act of 1987. Specifically, these comments address the export financing interest exception to the separate basket foreign tax credit limitations, the depreciation rules for computing earnings and profits of a foreign corporation with under 20 percent U.S. source income, passive foreign investment companies, the title passage rule and the alternative minimum tax foreign tax credit.

1. Export Financing Interest Exception

Code Section 904(d)(2)(G) defines export financing interest as interest received by a taxpayer or a related party engaged in manufacturing, producing, growing, or extracting certain U.S. exports. Under Code Section 904(d)(2), export financing interest is generally excluded from the separate limitations for passive, high withholding tax, and shipping income. The initial draft of the Technical Corrections Act of 1987 provides that export financing interest is financial services income if it is received by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, if such income is subject to a high withholding tax. Otherwise, such interest is treated as overall limitation income.

The Conference Report (page II-565) explains that an export financing interest exception to the separate limitation for passive income is necessary to minimize the risk that tax reform legislation will reduce the availability of export financing and thus have a negative impact on the volume of U.S. exports. The exception is accomplished by exempting export financing income from the new separate basket limitations created by Code Section 904(d)(2) and treating it as overall limitation income. In addition, if received by a bank, export financing interest is not subject to the repeal of banking income deferral under Subpart F.

Notwithstanding the Conferees' intention, under the definition of export financing interest, banks are ineligible to receive export financing interest because they are prohibited under U.S. banking laws from conducting non-banking activities such as manufacturing, producing, growing, or extracting goods for export and are prohibited from being a related party to such activities. The export financing exception, therefore, excludes banks which can neither be the eligible taxpayer nor a related person under Code Section 904(d)(2)(G).

The new Subpart F rules of Code Section 954(c)(2)(B) also provide that export financing interest received by banks is not foreign personal holding company income. This preserves in part the prior law bank income exception to the Subpart F rules [old Code Section 954(c)(3)(B)], the remainder of which is repealed. The preservation of the deferral, however, is not available to any U.S. bank since banks are ineligible to receive export financing interest.

The bill also requires that export financing interest be subject to a high withholding tax in order to be treated as financial services income by a banking, insurance, finance, or similar company. If such interest is subject to a gross basis tax of less than five percent, even if received by an entity predominantly engaged in the above activities, it is overall limitation income. The bill explanation states that this will allow manufacturers and the other listed eligible recipients of export financing interest to cross-credit low taxed export financing interest against other higher taxed overall limitation income. Thus, even if banks were eligible to receive such interest, placing it in the overall limitation (where banks have no other income) results in a loss of the benefits of such income and the foreign taxes paid thereon.

The Chamber believes that Code Section 904(d)(2)(G) should be amended to effectuate the Conference Report statements and the preservation of the Subpart F deferral rules by removing the requirement that such interest be received by a taxpayer or a related person engaged in manufacturing, producing, growing, or extracting goods for exports. The removal of these requirements would comport with the U.S. banking laws and would thus allow U.S. banks and their foreign subsidiaries to be eligible to receive export financing interest income. In addition, a technical correction should be made to exclude the requirement that export financing interest be subject to a high withholding tax in order to be treated as financial services income where that interest is received by an entity predominantly engaged in the active conduct of a banking business.

2. Depreciation Rules for Computing Earnings and Profits of a Foreign Corporation with Under 20 Percent U.S. Source Income

Prior to the Tax Reform Act of 1986 (the "Act"), foreign corporations less than 20 percent of whose gross income was derived from United States sources were permitted to use accelerated methods of depreciation over specified useful lives in computing their earnings and profits. This rule was contained in the last sentence of Section 312(k)(4) which provided that such foreign corporations, in determining earnings and profits, should employ the rules of pre-Act Section 168(f)(2). Section 168(f)(2) provided for either (1) accelerated methods of depreciation or (2) an election to use straight line depreciation. The legislative history of the Act reveals no intent to change this rule. Nevertheless, while the Act deleted the last sentence of section 312(k)(4), Congress inadvertently did not add a provision to Section 312(k)(4) which would expressly allow such foreign corporations to continue using the pre-Act methods of depreciation for purposes of computing their earnings and profits.

The deletion of the last sentence of Section 312(k)(4) was made in Act Section 201(d)(6) as part of the technical and conforming amendments to Act Section 201, which modified the accelerated cost recovery system. Thus, it appears that the deletion of the last sentence of Section 312(k)(4) was not intended to be substantive. In confirmation of that fact, the Conference Agreement, in its description of the alternative cost recovery system, indicates that the new alternative cost recovery system (straight-line depreciation over specified lives) applies for: (1) property used predominantly outside the United States, (2) tax-exempt use property, (3) computing earnings and profits of a domestic corporation or an "80-20 company", and (4) the minimum tax provisions. Conf. Rep. No. 99-841, 99th Cong. 2d Sess. II-44. The Conference Agreement does not indicate that any change was intended in the depreciation rules for computing the earnings and profits of a foreign corporation less than 20 percent of whose gross income is United States source.

Based on the foregoing, the Chamber recommends that a technical correction be made to clarify that the law is in accordance with the intent of the Act so that the depreciation rules applicable in determining the earnings and profits of a foreign corporation that derives less than 20% of its income from United States sources include the accelerated methods as per the Internal Revenue Code of 1954 as amended by Section 201(a) of Public Law Number 97-34. Accordingly, we recommend that the following language be added at the end of Section 312(k)(4):

> In determining the earnings and profits of such a corporation, in the case of recovery property the rules of Section 168(f)(2) shall apply.

3. Passive Foreign Investment Companies (PFIC)

A PFIC is defined in the Act to include any foreign corporation if either 75% or more of its gross income is passive or at least 50% of the average value of its assets produces passive income. For this purpose, a foreign corporation is deemed to own the passive income and passive income producing assets of its lower tier subsidiaries. The definitional test is applied without regard to the number or percentage of U.S. shareholders.

If a foreign corporation is categorized as a PFIC, the U.S. tax consequences are quite severe. Under the Act, the PFIC loses the economic benefit of tax deferral for its earnings by means of an interest charge mechanism that would operate upon distributions of earnings to U.S. shareholders and upon dispositions of PFIC stock. In addition, distributions of income from a PFIC will not generate Section 902 foreign tax credits for taxes paid by the PFIC in a foreign country. As an alternative, these consequences can be avoided if the PFIC makes a special "qualified electing fund" election for its U.S. shareholders, who are to be taxed currently on their proportionate share of the PFIC's income. However, in the event of such election, the income would fall into the separate foreign tax credit basket for passive income and so would be ineligible to absorb excess foreign tax credits generated by other active operations of the U.S. shareholder's group. These provisions generally take effect for tax years beginning in 1987.

The problem with the PFIC provisions is that they are overly broad in scope. As originally drafted, they had the limited purpose of restricting only passive foreign investment funds which were being used by individual U.S. investors to avoid U.S. tax on passive assets. Both the House and Senate versions of the provisions covered only these passive funds, and precluded any overlap that would impose additional tax or penalty on any controlled foreign corporation (CFC) that was already subject to the full panoply of Subpart F rules designed to tax passive foreign income. However, the CFC anti-overlap provisions were omitted from the final version of the Tax Reform Act. The overly harsh result is that the restrictive PFIC provisions now apply not only to passive funds, but also to any CFC with active business operations that generate and accumulate significant cash.

The first draft of the Technical Corrections Act of 1987 contains amendments that somewhat mitigate the PFIC problem. First, the draft removes the restrictions on the availability of Section 902 to generate foreign tax credits on distributions of PFIC income. Second, the draft creates a new look-through rule under the foreign tax credit passive basket provisions, with the effect that PFIC's income would no longer be treated as falling into a separate passive basket. However, the draft contains no amendment correcting the overlapping application of the interest charge rules to U.S. shareholders of a CFC. Therefore, even if the mitigating amendments are enacted, deferral will still be effectively terminated for the active business profits of a CFC that falls under the PFIC rules.

This termination of deferral for any CFC is clearly inappropriate. Congress specifically retained deferral for active income of CFC's though Congress' intent was not put into effect. Therefore, the Chamber recommends adoption of a technical correction which would provide that the PFIC rules are inapplicable to any CFC already subject to the rules of Subpart F.

4. Title Passage Rule

The Act retained the title passage rule for sourcing the income from the sale of inventory property and required that the Treasury Department study the effect of the title passage rule in light of the act's lower tax rates and in light of Congressional trade concerns, and report their findings to Congress by September 30, 1987.

The Chamber believes that other departments besides the Treasury Department may have different expertise bearing on the impact that the title passage rule has on U.S. exports and U.S. competitiveness. Thus, the Chamber recommends adoption of a technical correction amendment requiring that the Commerce Department and the office of the U.S. Trade Representative join Treasury in conducting the study on the title passage rule and to delay the report date of the findings by one year to September 30, 1988. This would result in a more comprehensive and accurate study showing why the current rules provide incentives to U.S. exporters with important trade and competitive ramifications.

5. Alternative Minimum Tax Foreign Tax Credit

The Act replaced the old "add on" corporate minimum tax with an Alternative Minimum Tax. The corporate Alternative Minimum Tax is applied to a broader income base (regular taxable income plus adjustments and preferences) and at a lower rate than the regular tax and is payable to the extent it exceeds the regular tax liability. Foreign tax credits as limited by Code Section 904 are allowed as an offset to the minimum tax. However, foreign tax credits cannot offset more than 90 percent of the minimum tax liability.

Allowing a taxpayer to offset no more than 90 percent of the minimum tax liability with foreign tax credits will undermine basic foreign tax credit principles. Disallowing or limiting all other business tax credits in a minimum tax scheme (as is done by the Act) does ensure some threshold of taxation on the related income, but disallowing any portion of a taxpayer's foreign tax credits only ensures international double taxation. The foreign tax credit does not exist to encourage any particular activity (i.e., it is not a preference), and its use does not permit a corporate taxpayer to be effectively untaxed as could be the case with respect to income covered by other business tax credits.

The foreign tax credit exists simply to prevent the taxpayer's foreign source income, which has already been taxed by a foreign jurisdiction, from being taxed again by the U.S. The new provision undermines the basic principle of the foreign tax credit in precluding double taxation and sets a precedent for levying a minimum tax on foreign income regardless of the amount of foreign income tax paid on such income.

The Chamber believes that a technical correction is needed to ensure that foreign tax credits as limited by Code Section 904 be allowed to offset a corporation's minimum tax liability without limitation. To do otherwise would undermine the principle of avoiding double taxation, hurt the expansion of American business abroad and place the U.S. in a difficult position with respect to future negotiations on tax treaties.

Respectfully submitted,

David G. Koenig
Tax Attorney

VANDERBILT UNIVERSITY

NASHVILLE, TENNESSEE 37240 TELEPHONE (615) 322-7311

Dear Senator Baucus:

On behalf of Vanderbilt University, I am writing to comment on S. 1350, the Technical Corrections Act of 1987. Our main concern is that the bill should clarify that early retirement plans for faculty are not taxable as deferred compensation.

Early retirement plans for tenured faculty are in essence buy backs of an unlimited tenure contract. The availability of these plans is important to America's colleges and universities in a time of aging faculty populations, limited resources, and the legislated elimination of mandatory retirement. In order to make more tenured positions available for younger professors, it is necessary to keep early retirement plans available and affordable.

The Tax Reform Act imposed limitations on the deferred compensation arrangements available to employees of nonprofit organizations which paralleled limitations previously placed upon employees of public institutions (section 457). These changes impose two restrictions upon new deferred compensation plans: first, that eligible deferred compensation plans are limited to $7,500 per annum or 33 1/3 per cent of compensation; and second, that such plans are considered elective contributions for tax-sheltered annuity catch-up rules. Plans which exceed this amount are treated as immediately taxable to the beneficiary.

The Act does not specify that these early retirement plans are to be considered as deferred compensation. However, in January, 1987, the Internal Revenue Service (IRS) issued an interpretation (Notice 87-13, January 26, 1987) which treats these plans as deferred compensation. This broad definition should be corrected immediately as it has broad implications for the ability of schools like Vanderbilt to seek voluntary termination of tenure agreements.

Another issue of interest to us is the need for clarification that charitable gift annuities are not subject to the unrelated business income tax because they are not commercial insurance under section 501(m). This method of making charitable gifts, through which a donor may give an immediate gift to a nonprofit organization and receive back a specified income for life, is predominantly used by less wealthy donors.

Section 501(m) of the Tax Reform Act can be read to include charitable gift annuities, even through Congress enacted section 514(c)(5) in 1969 specifically to direct how charitable gift annuities are to be treated under the unrelated business income tax, and 514(c)(5) was not amended by the Tax Reform Act. A clarification is needed in order to give non-profits the use of this important giving method.

Thank you for the opportunity to comment. Please contact me if you or your staff needs further information.

Sincerely,

Jeff Carr
Vice Chancellor for
University Relations and
General Counsel

COMMENTS ON S. 1350
THE TECHNICAL CORRECTIONS ACT OF 1987
ON BEHALF OF VANDERBILT UNIVERSITY

1. S. 1350 should be clarified to state that early retirement plans for faculty are <u>not</u> taxable as deferred compensation.

2. S. 1350 should be modified to include a clarification that charitable gift annuities are not subject to the unrelated business income tax because they are not commercial insurance under Section 501(m).

Jeff Carr
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Planned and Investment Giving

Vassar

July 14, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance
S. D. 205
Washington, DC 20510

Dear Ms. Wilcox:

It is with great distress that I recently learned that the Technical Corrections Act of 1987 (H.R. 2636) does not yet clarify the position of charitable gift annuities under IRC Sec. 501(m). This omission in the Act places non-profit institutions, especially private higher education institutions, at a great disadvantage. It handcuffs these institutions when the need for dollars continues to grow due to the curtailment of federal funds for higher education. Thus, I urge you to work cooperatively with your esteemed colleagues to amend IRC Sec. 501(m).

It is important that charitable gift annuities not be confused with commercial type insurance and not be impacted by this section of the code. For more than 100 years, charitable gift annuities have provided donors with opportunities to support the institutions of their choice, definitely a democratic endeavor. The failure by Congress to amend this section of the code will destroy an opportunity for an individual's expression of choice and constrain both the individual and the not-for-profit institution.

Thus, it is important to amend this code now to reflect the differences between charitable annuities and commercial type insurance. Failure to do so may in fact eradicate a source of funds for charitable organizations. A source which historically has been used only by the small donor. I urge you to work for an amendment of this code, so that charitable annuities are not subject to the unrelated business income tax.

Sincerely,

Sue Hartshorn

Sue Peirce Hartshorn
Associate Director of Development
and Planned Giving

SPH/resj

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914-452-7000 Ext. 3052

KAYE VESELY

808 Piedra Vista N.E., Albuquerque, New Mexico 87123

August 30, 1987

The Senate Finance Committee
Laura Wilcox, Hearing Clerk
S D O B 205
Washington, D.C. 20510

Dear Senate Finance Committee:

I am writing in reference to the Technical Corrections Bill S1350, an amendment to the Tax Reform Act of 1986.

As a writer, I am dependent on the decisions and actions of others. Last year I had spent hours on an article, and it was accepted. The magazine requested that I have a photo taken of myself for publication. However, my article was never published because the magazine went out of business. I didn't get either my article or the picture back. That was time and expense for which I expected to be paid. However, with the 1986 tax law, I would not be able to deduct the expenses which I had.

I recently wrote an article for KAPPAN, a magazine for teachers. This magazine doesn't pay for articles. It is an honor to be published by the magazine, but I think that I should get to claim my postage expenses even if I'm not paid for the article. There are many educational journals which don't pay to publish information important in a variety of fields. Teachers usually write for those journals. Is it fair to prohibit them from claiming the expenses incurred in sharing knowledge with other professionals?

Some of the writing that I have done has been for the League of Women Voters. There is no salary for that. I also worked with Albuquerque Healthcare For the Homeless in preparation of their newsletter. There's no monetary compensation for that either. I had no expenses in this work except my time. How do I place a value on my time? I have a Master's degree and lots of experience. When I taught, I made $16 an hour. Is my time worth less now because I write?

When I volunteer my skill, I can be sure that the work will be accepted. However, this is not at all true when I write for a magazine. I send queries and hope for interest. However, even a positive response is usually a promise to read what I've written. Then, as happened to me last year, even if the article is accepted, the magazine may go out of business.

Please consider these problems when you examine the Tax Reform Act of 1986 and changes that are necessary.

Sincerely,

Kaye Vesely

Kaye Vesely

VINSON & ELKINS
ATTORNEYS AT LAW

TECHNICAL CORRECTION CONCERNING SUBPART F

Amendment to Clarify Application
of Subpart F to Certain Partners in U.S. Partnerships

[Code §§951, 954, and 702;
Tax Reform Act §1221, 1222, and 1223]

Background

Under the provisions of Subpart F, a United States person may be required to include in gross income certain kinds of income earned by a controlled foreign corporation, even though not distributed. The application of Subpart F is limited to "United States shareholders" -- United States persons who own, or by attribution are considered as owning, at least 10 percent of the total combined voting power of the voting stock of a foreign corporation. Congress deemed it inappropriate to require recognition of the undistributed earnings of a foreign corporation by U.S. taxpayers with a relatively small interest in and only limited ability to control the policy of a foreign corporation, especially the policy with regard to distributions of earnings. In determining ownership of a CFC, the attribution rules of Code §958 apply. A partner in a U.S. partnership is thus deemed to own for purposes of Subpart F a proportional share of the stock of a foreign corporation owned by the partnership equal to the partner's interest in the partnership.

The Code does not make it sufficiently clear that Subpart F does not apply to a taxpayer whose only interest in a controlled foreign corporation ("CFC") is by attribution from a partnership and whose proportional interest in the CFC stock owned by the partnership is less than 10 percent. 1/ Such a partner is not a "United States shareholder" within the meaning of Subpart F. Furthermore, the interest of such a partner in the earnings of the CFC is relatively small, and the control that such a partner can exercise over corporate policy of the CFC by virtue of his partnership interest is as attenuated as that of any other shareholder with less than a 10 percent interest in the CFC. Nor is such a partner permitted to make an election under Code §962 in order to obtain a foreign tax credit for taxes paid by the CFC because that provision is limited to individuals who are United States shareholders. Thus, application of Subpart F under these circumstances is generally inconsistent with the policy and statutory scheme of Subpart F. However, where a partnership is a United States shareholder, an argument could be made that Subpart F income flows through the partnership to all of its partners, no matter how small their interest.

Proposed Clarifying Technical Correction

Code §§951(a) and 702 should be amended to clarify that a partner in a U.S. partnership is not required to include Subpart F income with respect to stock of a foreign corporation owned by the partnership unless the partner is a "United States shareholder" within the meaning of Code §951(b).

Reasons for Amendment

I. The Statutory Pattern

Section 951(a) requires that a "United States shareholder" include in gross income a pro rata share of the Subpart F income of a CFC. The term "United States shareholder" is defined in section 951(b) to mean

> a United States person (as defined in section [957(c)]) who owns (within the meaning of section 958(a)), or is considered owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

Section 958(b) provides that, in general, the attribution rules of section 318(a) apply to the extent the effect is to treat any United States person as a United States shareholder. A partner in a U.S. partnership is thus considered constructively to own a proportionate share of partnership stock by virtue of section 318(a)(2)(A).

Applying these rules, if a partner owns a one-percent interest in a domestic partnership that in turn owns 100 percent of the voting stock of a foreign corporation, that partner is considered to own only one percent of the stock of the foreign corporation. Thus, such a one-percent partner is not a United States shareholder within the meaning of section 951(b). And it therefore follows that such a one-percent partner is not required to include Subpart F income in his gross income because section 951(a) is limited in its application to "United States shareholders":

> In General. -- If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, <u>every person who is a United States shareholder</u> (as defined in subsection (b)) of such corporation and who owns (within the

> meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends -- [his pro rata share of the Subpart F income of the CFC].

Code §951(a)(1) (emphasis added).

It is true that a domestic partnership that owns 100 percent of the voting stock of a foreign corporation is itself a United States shareholder. 2/ But Subpart F income is not an item of partnership gross income a distributive share of which a partner is specifically required separately to include in his gross income under section 702 and Treas. Reg. section 1.702-1(a)(1)-(8). And, as discussed below, to require an inclusion of partnership Subpart F income by a partner considered to own less than 10 percent of the voting power of a foreign corporation would not only conflict with the plain meaning of section 951(a)(1), but also would be fundamentally inconsistent with the policy and legislative history of Subpart F.

The conclusion that such a partner is not required to include any Subpart F income is borne out by the similarly restricted scope of section 962. Section 962 is an elective relief provision for noncorporate taxpayers required to include Subpart F income. Under section 962, a "United States shareholder who is an individual" may elect to be taxed as a corporation and thus receive a section 960 foreign tax credit for foreign income taxes paid by a CFC attributable to Subpart F income. The express purpose of section 962 was to ensure that an individual with a direct investment in a CFC would not bear a heavier tax burden under Subpart F than would an individual investor in a U.S. corporation doing business abroad. S. Rep. No. 1881, 1962-3 C.B. 703, 798 (Senate Report on Revenue Act of 1962). Yet, if an individual partner considered to own less than 10 percent of a CFC were required to include in income his share of partnership Subpart F income, such a partner would not qualify to make the election under Section 962, and so would be required to bear a heavier tax burden. If Congress had intended such a partner to include in gross income the Subpart F income of a CFC, it would not have limited section 962 to 10-percent United States shareholders who are individuals, but would have included either partnerships themselves or individual partners considered to own less than 10 percent of the voting power of a CFC. The fact that Congress did not do so is clear evidence it never intended that such partners include Subpart F income in their gross income. 3/

II. Policy Considerations

The purpose of the 10-percent threshold for inclusion of Subpart F income is to limit application only to taxpayers who have a substantial interest in a foreign corporation and who are capable of exercising active and effective control over corporate policy, especially the policy with regard to utilization of corporate earnings. The House Report on the Subpart F provisions of the Revenue Act of 1962 explained the 10-percent test in this way:

> This de minimis rule prevents the attribution of undistributed income back to the shareholders where their interest is small and their influence on the corporation's policy is presumably negligible. The 10-percent ownership test is determined by applying stock ownership attribution rules set forth in the bill.

H. Rep. No. 1447, 1962-3 C.B. 405, 463.

An individual partner cannot exercise unfettered control over partnership property, including stock of a foreign corporation owned by the partnership. Instead, an individual partner's control over partnership property is limited to his beneficial (and voting) interest in the partnership; the other partners have similar rights and can also exercise control equal to their respective beneficial interests. As a result, the derivative control an individual partner can exercise over a foreign corporation through the partnership is equivalent to the individual partner's proportional share of that stock. A partner whose voting interest in a partnership is less than 10 percent thus cannot as a result of that interest exercise the same control over a CFC wholly owned by the partnership as a person who owns 10 percent or more of the voting stock of a foreign corporation.

In this regard, consider the example of two partnerships, P1 and P2, each owning 100 percent of the stock of a foreign corporation (FC1 and FC2, respectively). P1 has 100 equal partners, and P2 has 5 equal partners. Clearly, each of the P2 partners has a substantially greater degree of control over FC2 than any one of the P1 partners has over FC1. Moreover, if P1 and P2 distributed pro rata to their partners the stock of FC1 and FC2, the P1 partners each would receive only 1 percent of the stock of FC1, while the P2 partners each would receive 20 percent of the stock of FC2. In this latter case, the P1 partners would not be U.S. shareholders of FC1 (assuming no attribution of stock ownership between partners), while the P2 shareholders would be U.S. shareholders of FC2. The fact that the stock of FC1 and FC2 is held by P1 and P2 instead of by their partners should not obscure the fact that, on the individual partner level, the degree of voting control is the same as it would be if the stock of FC1 and FC2 were owned directly.

This limitation on an individual partner's control over a corporation in which the partnership owns an interest was recognized by Congress and reflected in the Subpart F attribution rules. Section 958(b) generally incorporates the constructive ownership rules of section 318 for purposes of applying the definition of a "United States shareholder." Section 318(a)(2)(A), of course, clearly provides that stock owned by a partnership is considered as owned by its partners in proportion to their respective beneficial interests in the partnership. The section 318 constructive ownership rules have been part of the Code since 1954, Pub. L. No. 83-591, §318 (1954); see H.R. Rep. No. 1337, 1954 U.S. Code Cong. & Ad. News 4025, 4061, 4234-35; S. Rep. No. 1622, 1954 U.S. Code Cong. & Ad. News 4621, 4890-91, and they are the rules now generally applied to determine control of a corporation for a variety of purposes. Although the application of the section 318 rules is sometimes modified to adapt them to varying statutory schemes and policies, we are aware of no instance in which the partnership proportional attribution rule has been altered. 4/ The congruence of the proportional attribution concept with actual control of a corporation is thus universally recognized in the Code.

Fundamental fairness issues would be confronted if partners with de minimis derivative interests in a foreign corporation were required to include in gross income a portion of the corporation's undistributed earnings. The legislative history of Subpart F shows that Congress was very concerned that the imputation of undistributed corporate earnings to U.S. taxpayers might well violate the due process clause of the U.S. Constitution. Testimony on this issue was taken by the Ways and Means Committee. Hearings Before the House Committee on Ways & Means on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress, April 20, 1961, 87th Cong., 1st Sess. 309-318, 340-42 (1961) (testimony of Treasury Secretary C. Douglas Dillon). And the Treasury Department was commissioned to prepare a memorandum of law. Id. at 313, 316-18 (Treasury memorandum on constitutionality of proposed Subpart F). The upshot was that the 10 percent voting control requirement was viewed as a minimum threshold consonant with fundamental fairness. Without at least that degree of control over corporate policy with respect to the application of earnings, it would be unfair to tax earnings before they are received by the taxpayer. It would be inconsistent with the policy reflected in the 10 percent threshold to impute Subpart F income to partners with derivative interests that do not cross that threshold, and indeed may be negligible as there would be no minimum interest of a partner that could not be affected.

II. The Tax Reform Act of 1986

Sections 1221, 1222, and 1223 of the Tax Reform Act of 1986 greatly expanded the categories of Subpart F income, and the exceptions to Subpart F were tightened or eliminated entirely. At the same time, the indirect credit and Subpart F foreign tax credit provisions were amended to alter the method for determining a U.S. shareholder's share of taxes paid by a CFC. The changes made by the 1986 Act, in creating new types of Subpart F income, have potentially caused these provisions to apply to many companies for the first time. For example, prior to 1987 foreign income of an active banking business was exempt from Subpart F. In repealing this exemption, the 1986 Act could potentially cause for the first time the application of Subpart F to partners in U.S. partnerships engaged in an active banking business through a foreign corporation.

IV. Conclusion

Sections 951(a) and 702 should be clarified to provide that they do not require the inclusion of Subpart F income of a foreign corporation by a partner in a domestic partnership unless that partner is himself a United States shareholder of the foreign corporation within the meaning of section 951(b). 5/

Supplemental Information

This statement is submitted by John E. Chapoton, Thomas A. Stout, Jr. and Christine L. Vaughn of VINSON & ELKINS, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of GOLDMAN, SACHS & CO.

1/ Nor has any administrative or judicial precedent been found on this issue.

2/ The term "United States person" is defined in section 7701(a)(30) to include U.S. partnerships. Therefore, a partnership that owns 100 percent of the voting stock of a foreign corporation is a United States shareholder within the meaning of section 951(b). See note 4, infra, for a discussion of the relevance of this classification.

3/ A contrary view of Subpart F would require an amendment to Code §962 to permit a partner with less than a 10 percent interest in a CFC the option to elect to be taxed as a corporation and receive a section 960 foreign tax credit. Such an amendment would be essential to place such partners on an equal footing with individual United States shareholders of controlled foreign corporations who clearly have Subpart F income.

4/ Section 958(b)(2) does modify the entity attribution rules to provide that a partnership, trust, estate, or corporation that owns 50 percent of the combined voting power of a foreign corporation shall be considered as owning all of the stock entitled to vote for purposes of applying the definition of a "United States shareholder." The effect of section 958(b)(2) may thus be to increase the constructive ownership share of an individual partner. The proportional allocation rule itself is not modified, however.

5/ It should be noted that the classification of a partnership as a United States shareholder is still meaningful, even though partners who are not themselves United States shareholders do not include Subpart F income. There are two requisites in section 951(a)(1) for inclusion of Subpart F income: status as a 10-percent shareholder (directly, indirectly, or by attribution) and actual ownership of stock. A partner with a 10-percent derivative interest in a CFC through the partnership is a United States shareholder but would not himself be required to include Subpart F income attributable to that 10-percent interest. Instead, that Subpart F income is included in partnership gross income because the partnership owns the stock, and the Subpart F income is then allocated to a partner who is also a United States shareholder in proportion to his interest in the partnership. The point here is that there is no inclusion of partnership Subpart F income by a partner who is not a United States shareholder.

VINSON & ELKINS
ATTORNEYS AT LAW

PROPOSED TECHNICAL CORRECTION TO FICA AND FUTA COMMON PAYMASTER PROVISIONS IN CODE §§ 3121(s) and 3306(p)

Background

Pursuant to the Federal Insurance Contributions Act ("FICA"), an excise tax is imposed on every employer with respect to each individual in his employ. The tax imposed is a percentage (currently 7.15%) of the base amount of wages paid to the employee (current $43,800). In general, when the same individual is employed by two or more employers, each is subject to the FICA tax on the base wages of the individual. The statute provides an exception where two or more related corporations concurrently employ the same individual and compensate him through a common paymaster which is one of the corporations. In such case, the tax is determined as though the individual has only one employer, the common paymaster. As a result, the tax is applied against only a single base amount of wages.

The common paymaster provisions of sections 3121(s) and 3306(p) were added to the Internal Revenue Code by the Social Security Amendments of 1977, Pub. L. No. 95-216, §§ 314(a), (c). The stated purpose of the provision was to eliminate the dual taxation that sometimes resulted from treating an employee as employed by more than one related corporation for purposes of employment taxes where the employee is paid by one of those corporations. The Senate Finance Committee report advances no policy reason for limiting the common paymaster provision to related corporations in its brief discussion of this provision. Apparently, the Committee simply did not focus on the common paymaster problem in the context of related entities other than corporations. S. Rep. No. 572, 95th Cong., 1st Sess. (1977), reprinted in 1978-1 C.B. 485, 486.

Proposed Technical Correction for Partnerships

The common paymaster rule of section 3121(s) of the Internal Revenue Code would be expanded to include partnerships and affiliated corporations. The rule would be available in the case of a corporation and a related partnership where the same persons own, directly or indirectly, more than 50 percent in value of the corporation's outstanding stock and more than 50 percent of the capital or profits interest in the partnership. A corresponding change would be made to the common paymaster rule of section 3306(p) of the Code to provide comparable treatment in the case of federal unemployment (FUTA) taxes.

The following language would be added to sections 3121(s) and 3306(p) of the Internal Revenue Code of 1986 (relating to concurrent employment by two or more employers) at the end of each section:

> For purposes of this section, a corporation and a partnership shall be deemed to be related corporations if the same persons own, directly or indirectly, (1) more than 50 percent in value of the outstanding stock of the corporation, and (2) more than 50 percent of the capital interest, or the profits interest, in the partnership.

Reasons for Amendment

It is unfair to require different organizational entities in an affiliated group each to pay the full amount of the FICA tax with respect to the same individual simply because he performs services for more than one entity in the group. This amounts to double taxation of the group.

Current section 3121(s) constitutes recognition that double taxation of an affiliated group is inappropriate and undesirable. Yet this provision unfairly discriminates against partnerships by failing to provide a mechanism similar to that available to related corporations to avoid double taxation of an affiliated group.

The exclusion of partnerships from the exception for affiliated groups is inconsistent with other provisions of FICA. For example, section 3121(l), adopted as part of the 1983 Social Security Act

Amendments, permits extension of the benefits of FICA to employees of a foreign affiliate of an "American employer," which is defined in section 3121(h) to include individuals, partnerships, and trusts, as well as corporations.

The filing of consolidated returns is not a prerequisite to application of current section 3121(s) to related corporations. Related corporations are defined in regulations to include 50% controlled corporations, or corporations with 50% or more common directors or officers, or 30% or more concurrent employees. The proposed 50% ownership rule in the related partnership-corporation situation thus tracks the existing rules for related corporations.

Supplemental Information

This statement is submitted by John E. Chapoton and Christine L. Vaughn of Vinson & Elkins, 1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1007, telephone no. (202) 639-6500, on behalf of Goldman, Sachs & Co.

July 17, 1987

A LAND-GRANT UNIVERSITY

VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY

Blacksburg, Virginia 24061

July 9, 1987

Ms. Laura Wilcox
U. S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I am writing to you with respect to the possible misinterpretation of IRC Section 501(m) as applied to charitable gift annuities. As many commentators have noted, Section 501(m) may be construed to treat charitable gift annuities as "commercial-type insurance." If this occurs, our charitable foundation (the Virginia Tech Foundation, Inc.) could be taxed as an insurance company because of our gift annuity program; or in an extreme case, it is our understanding that our Foundation could lose its tax exemption.

We submit that this would be most unfortunate, and we feel a totally unintended result of the Tax Reform Act of 1986. Therefore, we ask that you amend the Technical Corrections Act of 1987 (H.R. 2636) to clearly state that charitable gift annuities issued by 501(c)(3) organizations are not "commercial-type insurance" under IRC Section 501(m).

Charitable gift annuities are in no way "commercial insurance" products for the simple reason that they involve a donor who wants to make a gift to our university. Our charitable gift annuities do not compete with commercial annuities. We feel that if the law is not clarified, it will affect a very important source of gifts for Virginia Tech. It is also important to note, for the small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Section 501(m).

We trust you will see the clear difference between what our Foundation offers through a qualifying charitable gift annuity program as compared to "commercial type insurance" products. Our program is strictly for the purpose of providing private funds to insure the excellence of our university. Our program is not based upon generating profits for our Foundation, but is purely for the ultimate benefit of higher education in this country.

Very truly yours,

W.E. Lavery

W. E. Lavery
President

WEL:war

WASHINGTON THEOLOGICAL UNION
A Roman Catholic School For Ministry
9001 New Hampshire Avenue • Silver Spring, Maryland 20903-3699 • Telephone (301) 439-0551

July 6, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
SD 205
Washington, D.C. 20510

Dear Ms. Wilcox:

It has been brought to my attention that Charitable Gift Annuities may be subject to taxation under Section 501(m) of the Internal Revenue Code.

I do hope that you realize that these annuities are given as a charity and not as primarily income producing. Annuities have been used to help support good works for many decades. They are a way for the small donor to help a charitable cause. So, I would appreciate your help in clarifying the above-mentioned Section in such a way that it does not apply to Gift Annuities.

Thank you very much for your help in this matter.

Sincerely in Christ,

Vincent Cushing, O.F.M.

Rev. Vincent Cushing, OFM
President

VC/jl

WESLEYAN UNIVERSITY
Middletown, Connecticut 06457
(203) 347-9411 x2886

Office of Planned Giving

July 6, 1987

Laura Wilcox
U.S. Senate Committee on Finance
S.D. 25
Washington, DC 20510

Dear Miss Wilcox,

As a planned giving officer at Wesleyan University, I am opposed to the amendment in the Technical Corrections Act which would strike out IRC SEC. 2642(a)(2)(B)(ii)(II) and thereby completely eliminate the charitable deduction in computing the generation skipping transfer tax on lead trusts created after June 10, 1987.

This proposal represents a substantive change and should not be misrepresented as merely a technical correction. According to House Ways and Means Committee Chairman, Dan Rostenkowski, the Technical Corrections Act is not intended to make substantive changes to TRA 1986.

For Wesleyan University and other not-for-profit institutions, this sweeping amendment would discourage an important source of support. While our donors are primarily motivated by a desire to benefit their alma mater or favorite charity, the added incentive of tax savings often results in larger or multiple gifts. As direct Federal aid for education has diminished, continuing government support of philanthropy, as evidenced in the Internal Revenue Code, has become increasingly important.

On behalf of all not-for-profit organizations, I urge you to reconsider the proposed amendment as discussed above on the grounds that: 1) it is clearly substantive and, 2) it will discourage an important source of support for charitable organizations.

Sincerely,

Judy Pillon

Judy Pillon
Assistant Director of Planned Giving

JPP/llh

cc: Mary McAuliffe
U.S. Senate Committee on Finance

Since 1860
For Christ and
His Kingdom

Wheaton
College

WHEATON, ILLINOIS 60187 5593

July 1, 1987

U. S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Attention: Laura Wilcox

Dear Ladies and Gentlemen:

We were disappointed that the Technical Corrections Act of 1987 did not specifically say that gift annuities are not "commercial-type insurance" under IRC Section 501(m). Taxation of gift annuities under 501(m) would basically dry up an important part of our fund raising efforts and the fund raising efforts of many other charities.

It is important to note the following: (1) gift annuities are used because an interested donor wants to make a gift to help a charitable institution; (2) gift annuities don't compete with commercial annuities and are not "commercial type insurance"; (3) failure to clarify the law would dry up an important source of funds for our organization's charitable activities; (4) gift annuities have been used by charitable organizations for over 100 years; and (5) for the small donor, a charitable gift annuity is the equivalent of a large donor's charitable remainder annuity trust, which is unaffected by IRC Sec. 501(m).

We would very much appreciate it if the Senate Finance and House Ways and Means Committees would amend the Technical Corrections Act to clarify that charitable gift annuities issued by IRC Section 501(c)(3) organizations are not subject to IRC Section 501(m).

Very truly yours,

WHEATON COLLEGE

David A. Teune

DAT:BM

David A. Teune,
Investment Manager

Whitworth Foundation
Whitworth College
Spokane, WA 99251
509-466-3220

July 8, 1987

Ms. Laura Wilcox
United States Senate Committee on Finance
S.D. 205
Washington, DC 20515

Dear Ms. Wilcox:

Whitworth College is a Christian liberal arts college which is celebrating its centennial anniversary in 1990. The Whitworth Foundation has been instrumental in building the College endowment fund through a successful planned giving program.

Charitable lead trusts are an important source of support for many charitable institutions which work with planned giving. We are concerned about the repeal of the charitable deduction which offsets the generation-skipping tax on charitable lead trusts. This substantive change to the 1986 Tax Reform Act through the Technical Corrections Act would strongly discourage any future charitable lead trusts and would be contrary to the policy of Congress to encourage charitable gifts.

We urge you to amend this "technical correction" to the 1986 Tax Reform Act and keep the charitable deduction in the inclusion ratio formula for the generation-skipping transfer tax.

Sincerely,

Steve Trefts

Stephen Trefts
Executive Vice President

ST:aw

July 21, 1987

Ms. Laura Wilcox
United States Senate
Committee on Finance
S.D. 205
Washington, DC 20510

Whitworth Foundation
Whitworth College
Spokane, WA 99251
509-4[illegible]-3220

Dear Ms. Wilcox:

Whitworth College is a Christian liberal arts college which is celebrating its centennial anniversary in 1990. The Whitworth Foundation has been instrumental in building the College endowment fund through a successful planned giving program.

A key contribution to the endowment fund has been charitable gift annuities. Gift annuities are still a popular vehicle for deferred giving for the small donor.

We are very concerned about IRC Sec. 501(m) which does not exclude charitable gift annuities. The result of this oversight could be the taxation of charitable institutions which are the remainder beneficiaries of these gift annuities. If this law is not clarified, it would dry up an important source of scholarships and other educational funds for Whitworth College.

As you know, charitable gift annuities are very similar to charitable remainder annuity trusts, which are not affected by IRC Sec. 501(m). In addition, charitable gift annuities are not "commercial-type insurance."

We are urging you to amend the Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not considered "commercial-type insurance" under IRC Sec. 501(m).

Please make this a priority item when amending the Technical Corrections Act of 1987.

Sincerely,

Stephen Trefts
Executive Vice President

ST:aw

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June 18, 1987

Mr. William Wilkins
Chief Counsel
Committee on Finance
U.S. Senate
205 Senate Dirksen Office Bldg.
Washington, D.C. 20515

Dear Mr. Wilkins:

I am writing on behalf of the National Hydropower Association to comment on the recently introduced Technical Corrections Act, S. 1350.

The Tax Reform Act of 1986 contained a transition rule to the investment credit and depreciation changes for hydroelectric projects. That rule, contained in Section 204(a)(2) of the Act, provides as follows:

> (2) CERTAIN PROJECTS GRANTED FERC LICENSES, ETC. - The amendments made by section 201 shall not apply to any property which is part of a project -
>
> > (C) which is a hydroelectric project of less than 80 megawatts that field an application for a permit exemption, or license with the Federal Energy Regulatory Commission before March 2, 1986.

This rule contains two typographical errors. First, the word "field" appeared instead of "filed," and a comma was omitted following the word "permit."

House concurrent resolution 395, as printed in the Congressional Record of September 25, 1986, contained, in Paragraph 10, a provision to correct these errors:

> (10) On page 69, in the second line, strike out "field" and insert in lieu thereof "filed" and insert a comma after "permit".

Although this is a strictly "technical" correction, it was not included in S. 1350 as introduced. I hope that an appropriate correction will be included in any subsequent draft of the legislation.

Sincerely,

Lee M. Goodwin

LMG/smw

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A PROFESSIONAL CORPORATION
LAWYERS
1101 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20036

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J. D. WILLIAMS

TELEPHONE
(202) 659-8201

July 24, 1987

Ms. Laura Wilcox
Senate Finance Committee
205 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Laura:

Pursuant to your recent announcement, this letter is submitted to support a technical correction for inclusion in S. 1350. Specifically it concerns a proposed Technical Correction to Section 108 of the Tax Reform Act of 1984 as Amended by Section 1808(d) of the Tax Reform Act of 1986.

Summary

Recently, the Service has begun attacking straddles in stock options traded over regulated domestic exchanges which occurred prior to the enactment of the Tax Reform Act of 1984. (That Act brought such options under the statutory straddle rules first enacted in the Economic Recovery Tax Act of 1981.) The proposed technical correction would extend the coverage of section 108 of the Tax Reform Act of 1984 to such stock options, thereby preventing the Service from whipsawing investors in such options by disallowing the losses reported from each straddle while at the same time taxing them on their reported gains from the straddle. The proposed technical correction would also extend the irrebuttable trade or business presumption of section 108(b) applicable to commodities dealers' commodities straddles to options dealers' stock option straddles. The proposed technical correction would have no impact on the controversial issue of the degree of profit motive required to be demonstrated by straddle investors for recognition of their straddle losses.

Background

Prior to the Economic Recovery Tax Act of 1981 (hereinafter "ERTA"), numerous issues with respect to the taxation of straddles were unclear. The Internal Revenue Service had ruled in Rev. Rul. 77-185, 1977-1 C.B. 48, that no loss could be recognized on the disposition of a leg of a silver futures straddle until all of the legs of the straddle were disposed of and, in any event, even the net loss arising from the straddle could not be allowed because the taxpayer had "no reasonable expectation of deriving an economic profit from the transaction." In Smith v. Commissioner, 78 T.C. 350 (1982), the Service litigated the issues of Rev. Rul. 77-185 in the context of silver futures transactions entered into by customers of Merrill Lynch conducted on the COMEX. In Smith, the Tax Court rules that, contrary to Rev. Rul. 77-185, losses could be recognized on the disposition of a leg of a silver futures straddle even though other legs had not yet been disposed of. The Tax Court, however, concluded that the taxpayers therein did not have the requisite profit motive to deduct the recognized losses.

The Service was displeased with the ruling in Smith and moved for reconsideration of the case on April 2, 1982. The Service again requested the Court to rule that losses could not be recognized until all legs of a straddle were disposed of. In its motion, the Service warned that if the Tax Court did not change its position, the IRS "intends . . . to follow the logical consequences of the . . . opinion and seek the disallowance of the tax straddle losses, coupled with the recognition of tax straddle gains." Despite the Service's threat to whipsaw taxpayers, the motion for reconsideration was denied.

At the same time it was litigating the Smith case, the Service commenced litigation projects with respect to straddle transactions in other commodity futures, silver futures traded outside the United States, and options on U.S. Treasury Bills. In so doing, the Service did not limit its attack on straddles to ordinary investors, but broadened its attack to include dealer transactions as well.

In title V of ERTA, Congress provided statutory rules to prospectively govern the taxation of certain straddles. The straddles covered by ERTA included straddles in futures contracts, but did not include straddles in stock options of the kind ordinarily traded on domestic options exchanges. (See IRC §1092(d)(2)(B), as added by ERTA.) The rationale for such exclusion apparently was that straddles in domestic stock options could not be used to convert short-term capital gain to long-term capital gain and were thus less of a revenue concern. Conversion was impossible because domestic stock options would always expire prior to the long-term gain holding period. S. Rept. No. 97-144, 97th Cong., 1st Sess. 151 (1981).

In subtitle H of the Tax Reform Act of 1984 (hereinafter "TRA '84"), Congress repealed the exception of domestic stock options from the rules added by title V of ERTA. Henceforward, domestic stock options were generally governed by the loss deferral rules of IRC §1092 or, in the case of options dealers, by the mark-to-market rules of IRC §1256.

At the time TRA '84 was being considered, Congress became concerned with the huge backlog of pre-ERTA straddle cases which had accumulated in the Tax Court. In section 108 of TRA '84' Congress sought to provide some retroactive rules for the treatment of those straddles in order to speed the resolution of those cases. (H. Rept. No. 98-861, 98th Cong., 2d Sess. 917 (1984).) Those rules were as follows:

1. With minor exceptions, the fact that a position was held as part of a straddle would not be considered in determining whether there was gain or loss, the timing of such gain or loss, and the character of such gain or loss as short-term or long-term. TRA '84 §108(d). In light of this provision, the Treasury announced: "The closed and completed transaction argument [set forth in

Rev. Rul. 77-185] will not be made regarding transactions subject to section 108 of the Act." Temp. Reg. §1.165-13T (A-9) (August 21, 1984).

2. To prevent the Service from disallowing losses but taxing the gains from a straddle transaction where the taxpayer was held not to have had the requisite profit motive (i.e., the whipsaw which the Service had threatened in its motion for reconsideration in Smith), the disallowed loss in such a case would be allowed as an offset to the gain reported at the time the remaining positions of the straddle were disposed of -- i.e., the "net loss" from all the straddle positions was allowed to the taxpayer. TRA '84 §108(c).

3. Commodity dealers were rebuttably presumed to have engaged in their straddle transactions in commodities with the requisite profit motive to deduct their losses at the time of recognition. TRA '84 §108(b).

The above rules were made applicable to any pre-1982 "straddle" which was not the subject of ERTA's rules. For this purpose, "straddle" was defined as that term was defined in IRC §1092(c) immediately after its enactment by ERTA. TRA '84 §108(e). Since a straddle in domestic stock options was not treated as a "straddle" by ERTA, straddles in domestic stock options were not affected by the above rules of TRA '84 §108. Temp. Treas. Reg. §1.165-13T(A-1) ("Straddles in certain listed stock options were not covered by ERTA and are not affected by this provision.")

Shortly after the enactment of TRA '84 §108, it became apparent that a rebuttable presumption for commodities dealers was of little help in quickly resolving their cases. Accordingly, in section 1808(d) of the Tax Reform Act of 1986 (hereinafter TRA '86), TRA '84 §108(b) was modified to make the commodities dealer presumption irrebuttable "because of the inherent difficulty in distinguishing tax-motivated straddle transactions from profit-motivated straddle transactions when the taxpayer was in the trade or business of trading in commodities." H. Rept. No. 99-426, 99th Cong., 1st Sess. 910-911 (1985).

Recently, the Internal Revenue Service again broadened its attack on straddles to include an attack on pre-TRA '84 domestic stock option straddles -- particularly those entered into by options dealers (i.e., market makers registered with domestic options exchanges). It has done so, despite the fact that such straddles did not give rise to conversion of the character of income (i.e., from ordinary to capital or from short-term capital to long-term capital), and thus involved the least potential tax benefit, and despite the fact that substantial non-tax profits and losses are generated in stock options straddles (unlike certain other straddles where the potential for profit is small).

Reasons for Technical Correction

Investors and dealers who engaged in pre-TRA '84 domestic stock option straddles now face the same predicament formerly faced by investors and commodity dealers with respect to pre-ERTA straddles. The government, not constrained by TRA '84 §108, is once again threatening to raise its old arguments, which may include Rev. Rul. 77-185's closed and completed transaction theory and the whipsaw of the taxpayer through the taxation of straddle gains coupled with the disallowance of straddle losses. This latter argument is even more dangerous to taxpayers who engaged in domestic stock options straddles than it was to taxpayers who engaged in pre-ERTA straddles. Most pre-ERTA straddles involved the element of conversion -- e.g., losses were claimed as short-term capital but gains were reported as long-term capital. If losses in pre-ERTA straddles were disallowed, the phantom gains on which the taxpayer would pay tax would be long-term capital gains. By contrast, since pre-TRA '84 domestic stock options straddles did not involve the element of conversion, if losses were disallowed, the phantom gains on which the taxpayer would pay tax would be short-term capital gains and the phantom tax would be higher.

As Congress recognized in TRA '84 §108, there is no policy reason for taxing large phantom gains in straddle transactions in which the taxpayer actually lost (or earned) comparatively little money, net. In addition, to tax such phantom gains would be to place individuals who traded over regulated domestic exchanges in a worse position than those who engaged in fictitious or sham straddle trades. (The latter individuals could not be forced to pay tax on sham gains.) There is no policy reason why the anti-whipsaw benefits of TRA '84 §108(c) should not also extend to pre-TRA '84 domestic stock option straddles and it can only be assumed that the previous failure of TRA '84 §108(c) to cover domestic stock option straddles was an unintentional oversight.

Secondly, like commodity dealers, options dealers engage in numerous straddle trades in the course of their business. Straddle trades enable options dealers to reduce their risk in making a market in each option. For example, if one investor desires to purchase a call in Company A November options with a strike price of 100 and if a different investor seeks to sell a call in Company A November options with a strike price of 105, no trade would occur unless the dealer takes the opposite side of each of the above trades. A straddle forming the opposite side of the investors' trades would enable both trades to be completed at a lower risk to the dealer than if the dealer assumed the other side of each trade at different times. It would be extremely difficult for a court to determine which, if any, option dealer option straddles were not entered into in the ordinary course of business or were not entered into for profit. In order to prevent the wasting of resources (both the taxpayers' and the government's) in litigating option dealer straddle cases, where it would be unlikely in any event that the government would prevail, the irrebuttable trade or business presumption of TRA

'84 §108(b), as amended by TRA '86 §108(d), should be extended to options dealers.

It should again be noted that the proposed technical corrsction takes no position and has no effect the much-debated issue of the level of profit motive required for an investor to recognize losses in the case of straddles covered by TRA '84 §108. See Glass v. Commissioner, 87 T.C. 1087 (1986); Miller v. Commissioner, 84 T.C. 827 (1985), on appeal (10th Cir., Nov. 20, 1985); H. Rept. No. 98-861, 98th Cong., 2nd Sess. 917 (1984); H. Rept. No. 99-426, 99th Cong., 1st Sess. 911 (1985); 132 Cong. Rec. S13956 (daily ed. Sept. 27, 1986) (colloquy between Senators Dole and Packwood); 132 Cong. Rec. E3389, E3391 (daily ed. Oct. 2, 1986) (statement of Mr. Rostenkowski); Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation (Joint Committee on Taxation May 13, 1987) at 45; 133 Cong. Rec. S7696-S7697 (daily ed. June 5, 1987) (statement of Senator Dole).

Sincerely,

WILLIAMS & JENSEN, P.C.

Robert Glennon

Robert E. Glennon

WILMER, CUTLER & PICKERING
2445 M STREET, N. W.
WASHINGTON, D. C. 20037-1420

July 24, 1987

Ms. Laura Wilcox, Hearing Administrator
Committee on Finance
U.S. Senate
205 Dirksen Senate Office Building
Washington, D.C. 20510

Comments Suggesting Clarification of the Ordering Rule for Using Components of the General Business Credit and Requesting Clarification of Section 107(g)(2) of the Technical Corrections Act of 1987 (S. 1350)

Dear Ms. Wilcox:

These comments respond to the request, contained in the June 17, 1987 press release of the Committee on Finance, for comments on the Technical Corrections Act of 1987 (S 1350).

These comments request (1) confirmation that the components of the general business credit are to be utilized in the order in which they are listed in section 38(b) of the Internal Revenue Code of 1986 (the "Code"), (2) confirmation that subcomponents of the investment credit generally are utilized in the order set forth in section 46(a), (3) clarification that the reduction of regular investment credit carryforwards under section 49(c) of the Code shall proportionately reduce the credits carried forward from each year, and (4) clarification that section 107(g)(2) of S. 1350 expands the allowable general business credit for C corporations but does not provide an ordering rule for the utilization of the credit.

A. Clarification of the Ordering Rule for Components of the General Business Credit

When Congress amended the general business credit provisions in DEFRA by making the investment credit, the targeted jobs credit, the alcohol fuels credit, and the PAYSOP credit part of the section 38(b) general business credit, it failed to provide an explicit ordering rule for use of the components of the general business credit. That failure continued in the 1986 Act. Moreover, the Treasury Department has not issued regulations or published rulings that address the issue of the ordering of the components of the general business credit.

The ordering rules of present law need clarification. The most appropriate ordering rule is that the components should be utilized in the order listed in section 38(b) - first the investment credit determined under section 46(a), then the targeted jobs credit, etc. However whether that rule is in force under existing law is in doubt because section 38(d) adopts precisely that ordering rule as a "special rule" for regulated public utilities. Ostensibly, the special rule would not have been needed if a general rule provided the same result.

Section 49(c)(5)(C) further confuses the issue. Section 49(c)(1) provides for a 35-percent reduction in any portion of the business credit carryforward under section 38(a)(1) attributable to the regular investment credit which has not expired as of the close of the taxable year preceding the first taxable year of the taxpayer beginning after June 30, 1987. Section 49(c)(5)(C) specifies that

> the portion of any current year business credit or business credit carryforward which is attributable to the regular investment credit shall be determined on the basis that the regular investment credit is used first.

It is not clear how this rule interrelates with whatever ordering rule is mandated by section 38. For example, does section 49(c)(5)(C) mean that regular investment credit from 1985 would be used before targeted jobs tax credit from 1984? Or does the normal rule continue to apply that, in a carryforward year, carryforwards to that year are first claimed on a FIFO basis, then the business credit earned in that year is claimed? We understand from informal conversations with Joint Committee staff that the latter interpretation was intended. However, the meaning of the provision should be clarified.

The problem with not having an explicit and unambigious ordering rule is that taxpayers are left without guidance on important issues in filing their tax returns. For example, although the Conference Committee recognized that carryforwards of the investment-based employee stock ownership credit (or "TRASOP credit") are still available as part of the investment credit component of the general business credit (even though investments after 1982 could not qualify for additional TRASOP credits),[1/] it gave no guidance as to the order in which the investment credit component of the general business credit (or any subcomponents) would be utilized. This is an important question for taxpayers attempting to determine the proper year for funding their TRASOPs because the TRASOP must be funded in the year in which the credit is utilized.[2/]

We believe that in order to provide fair guidance to taxpayers, three changes should be made to the ordering rules. First, a general ordering rule should be set forth for components of the general business credit to the effect that credits should be used in the order in which they are listed in section 38(b). This rule would be consistent with the rule endorsed in the Senate Finance Committee Report.[3/]

Second, the Code should provide that subcomponents of the investment credit are utilized in the order set forth in section 46(a). This rule would be consistent with present IRS ruling practice.[4/]

The foregoing amendments could be achieved by amending section 38(d) of the Code to make it generally applicable rather than restricting its application to certain regulated companies. Preferably the amendment would be treated as a DEFRA technical correction so that the guidance would apply retroactively to the point at which the old ordering rules were repealed.

The statute should also provide for the situation where a component of the general business credit or a subcomponent of the investment credit is deleted from the statute or its order in the statute is changed.[5/] Generally, order should be determined by the order in the statute at the time the carryover is used or, in the case of a subcomponent of the investment credit which is no longer listed, in the order in which that subcomponent appeared when the property was placed in service or the credit was otherwise earned. If the statute no longer references a component at the time of use, it should be utilized after the components listed in section 38(b).[6/]

As amended, section 38(d) would provide --

> ORDERING RULES.--In the case of any taxpayer, for purposes of sections 46(f), 47(a), 196(a) and any other provision of this title where it is necessary to ascertain the extent to which the credits determined under sections 40(a), 41(a), 42(a), 46(a), or 51(a) and section 41(a) of the Internal Revenue Code of 1954 (as in effect on the day before the enactment of the Internal Revenue Code of 1986) and carryforwards under section 39(d)(1) of the Code are used in a taxable year or as a carryback or carryforward, the order in which such credits are used shall be determined on the basis of the order in which they are listed in subsection (b) and, in the case of the investment credit, in the order in which the subcomponents of the investment credit are listed in section 46(a) (or were listed in the year in which the property was placed in service or the credit was otherwise earned). For purposes of this subsection, order should be determined by the order in subsection (b) at the time the carryover is utilized. Components of the general business credit that are not listed in subsection (b) shall be utilized, after the listed components, in the order in which they would be have been utilized in the year from which they were carried forward.

Third, section 49(c)(5)(C) should be amended so that it cross-references the general rule and clarifies that the 35-percent reduction is applied proportionately against the regular investment tax credits carried to 1987:

(C) Portion of Credits Attributable to Regular Investment Credit. -- The portion of any current year business credit or business credit carryforward which is attributable to the regular investment credit shall be determined under subsection (d) of section 38. The amount of the reduction of the regular investment credit carryforward under this subsection shall be deemed to reduce the regular investment credit carryforwards from a given taxable year in proportion to the ratio of that year's regular investment credit carryforwards to the total carryforwards reduced under this subsection.

For example, a calendar year taxpayer places property in service in 1984 and 1985 and claims regular investment credits of $2 and $10 for those years. It carries the credits forward to 1987. Pursuant to section 49(c)(3), it reduces the $12 of regular investment credits by $2.10 (17.5 percent of $12). It then reduces its 1984 carryforward by $0.35 ($2.10 times $2/$12) and its 1985 carryforward by $1.75 ($2.10 times $10/$12).

The manner in which the ordering rules should work under the clarifying amendments suggested above can be illustrated by the following example:

A calendar year taxpayer earns the following credits in 1982: $100 of regular investment tax credit, $10 of TRASOP credits, and $10 of research credits. It carries the credits forward to 1987 in which year it earns $10 of regular investment tax credits from transition property and $10 of research credits. In the first instance, the 1987 transition regular investment tax credit is reduced by 17.5 percent to $8.25 and the 1982 regular investment tax carryforward is reduced by 17.5 percent to $82.50. Because of the application of the 75% limitation on general business tax credits, assume further that only $90 of the credit is used in 1987. This $90 will be utilized in the following order: $82.50 of 1982 regular investment tax credits and $7.50 of TRASOP credits.[7] The taxpayer will fund its TRASOP with a contribution reflecting the $7.50 of credit utilized in 1987.

The taxpayer will carry forward $30.75 to 1988, plus a gross up equal to $1.75 (the adjustment provided under section 49(c)(4)(B)(ii), using the language of S. 1350). The $8.25 of 1987 regular investment tax credit and the $1.75 of gross up credit are added together and then reduced by 35 percent to $6.50. Because of the 75% limitation on general business tax credits, assume that only $25 of the credit may be used in 1988. The total carryforward that could be utilized in 1988 will be $25 utilized in the following order: $2.50 of 1982 TRASOP credit, $10 of 1982 research credit, $6.50 of 1987 regular investment tax credit, and $6 of 1987 research credits, leaving $4 of 1987 research credits to be carried forward to 1989.

B. Revision of Section 107(g)(2) of S. 1350

The Committee should also revise section 107(g)(2) to clarify that the ordering rule for purposes of determining the amount of the allowable credit is not the ordering rule for utilization. The technical correction in its present form could be read to reverse the customary ordering in using the components of the general business credit: allowing use of the regular investment tax credit only after use of the other components of the general business credit.

1. General Business Credit Limitation Under Section 38(c) of the 1986 Code

Section 38(c)(1) of the Code provides the general limitation on the utilization of the general business credit under section 38(a). Before enactment of the Tax Reform Act of 1986, a corporate taxpayer could offset its regular income tax, but not its minimum tax, with the general business credit. Section 38(c)(1) of the Code retained that general rule by limiting the allowable general business credit to the lesser of (1) the sum of (A) so much of the net regular tax liability as does not exceed $25,000 and (B) 75 percent of so much of the net regular tax liability as exceeds $25,000 and (2) the excess of the net regular tax liability over the tentative minimum tax for the year.

Congress enacted a special limitation for C corporations, permitting them to make greater use of the general business credit.[8/] It added paragraph (3) to section 38(c) to provide that a C corporation could use its regular investment tax credits to offset a portion of its tentative minimum tax if it would otherwise be subject to the minimum tax.9/

2. Section 107(g)(2) of S. 1350

S. 1350 could be read to permit use of the regular investment tax credit to offset corporate minimum taxes only if the other components of the general business credit are first exhausted. The accompanying Joint Committee description of this provision says only that the computation of the allowable limit will be made as if the other components were used before the regular investment tax credit:

> Investment tax credits.--The bill clarifies that the total amount of the general business credit allowable to a C corporation for a taxable year in which the regular tax exceeds the tentative minimum tax is determined as if any portion of the general business credit not attributable to the regular investment tax credit first offset the regular tax, and the regular investment credits (to the extent otherwise available) then reduced the net tax to 75 percent of the tentative minimum tax.10/

We suggest that the Committee clarify that the proposed amended section 38(c)(3) is used to determine the amount of the allowable general business credit for purposes of section 38(c) and does not address the order in which C corporations in fact utilize those credits. The ordering in section 107(g)(2) appropriately implements Congressional intent to expand the allowed general business credit for C corporations, but if the technical correction were deemed to specify the order for utilization, it would be inconsistent with what appears to be the correct rule: namely, that components of the general business credit generally should be utilized in the order listed in section 38(b). Under that order, the investment credit, of which the regular investment credit is a subcomponent would be utilized first.

Sincerely,

F. David Lake, Jr.

F. David Lake, Jr.

R Scott Kilgore

R. Scott Kilgore

1/ "Thus, for example, 100 percent of ITC carryovers may continue to be allowed for funding an investment tax credit employee stock ownership plan." H.R. Conf. Rpt. No. 841, 99th Cong., 2d Sess. at II-64 (1986).

2/ See Section 48(n)(1) of the Internal Revenue Code of 1954, before that subsection's repeal in DEFRA: The TRASOP credit "shall not apply . . . unless the taxpayer on his return for such taxable year agrees . . . to make transfers of employer securities to a [TRASOP] . . ., to the extent allocable to that portion of the [TRASOP] credit which is allowed as a carryover in a succeeding taxable year, not later than 30 days after the due date (including extensions) for filing the return for such succeeding year."

3/ See the Senate Finance Committee's description of the reduction of ITC carryforwards in which it stated that --

> [i]f a regular investment tax credit is allowable for a taxable year beginning after December 31, 1986, the amount allowable is reduced by 30 percent (15 percent, in the case of credits allowable for a taxable year beginning in 1987). . . . For purposes of determining the extent to which an investment credit determined under section 46 is used in a taxable year beginning after December 31, 1986, the order in which other credits included in a taxpayer's general business credit are used shall be determined on the basis of the order in which they are listed in section 38(b).

S. Rpt. No. 313, 99th Cong., 2d Sess. 115 (1986).

4/ See LTR 8645044 (August 11, 1986).

5/ Alternatively, the statute could provide a summary table setting forth the ordering which result from the rules we propose for section 38(d).

6/ This problem arises, for example, with PAYSOP credits or WIN credits carried to 1987. Carryforwards of WIN credits enter the issue of utilization of the general business credits because section 39(d) of the Code made unexpired pre-DEFRA carryforwards a general business credit carryforward.

Although we cannot think of a situation in which this would occur, we suggest that if the taxpayer has more than one component from a given year which is no longer referenced, it would utilize those components in the order in which they would have been utilized in the year from which they were carried but after it utilized the listed components of section 38(b).

7/ Because the research credit is listed in section 38(b) for 1987, it is utilized in the order shown in that subsection. Because the TRASOP is no longer listed, it is utilized in the order which existed when the property with respect to which the TRASOP credit is earned was placed in service.

8/ The staff of the Joint Committee on Taxation explained that "[i]n order to provide transition relief, corporations are permitted to use regular investment tax credits to offset up to 25 percent of minimum tax liability." 1986 Bluebook at 437-38.

9/ The 1986 Act did not make clear the interrelationship between the (c)(1) limitation and the new provision in (c)(3). Although it seems clear that section 38(c)(3) was intended to permit C corporations to use an additional portion of its general business credits, the lack of a cross reference to section 38(c)(1) left open the possibility that (c)(3) could be misread to be an alternative to (c)(1), rather than a supplement. Section 107(g)(2) of S. 1350 makes clear that C corporations may utilize an additional portion of its general business credits. But in making this commendable clarification, S. 1350 raises new problems discussed herein.

10/ Staff of the Joint Committee on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350) at 63 (June 15, 1987).

APPENDIX

GENERAL BUSINESS CREDIT LIMITATION EXAMPLES
(Dollars in Millions)

Example 1

Credits earned & carried forward to 1985:

	1981	1982	1983	1984	1985	Total
Regular ITC	29	18	16	14	10	87
TRASOP 1%	3	2	0	0	0	5
TJTC	1	1	1	1	1	5
Research	10	8	7	6	5	36
Win Credit	4	0	0	0	0	4
PAYSOP	0	0	2	3	4	9
Total	47	29	26	24	20	146

1985 tax liability	76
Credits allowed:	
Research	36
General business credit	34
Total credits allowed	70
Net tax	6

Notes:

1) In 1985 the research credit was not part of the general business credit; it had its own limitation.

2) The $34 of general business credit is made up of full $29 of 1981 regular ITC, the $3 of 1981 TRASOP credit, the $1 of 1981 Targeted Jobs Tax Credit, and $1 of 1981 WIN credit. The TRASOP credit is used in the order in which it appeared in section 46(a) when the property with respect to which it is claimed was placed in service. Since the WIN credit is not listed in section 38(b), it is used after all the listed credits.

Example 2

Credits earned & carried forward to 1985:

	1981	1982	1983	1984	1985	Total
Regular ITC	10	21	16	14	10	71
TRASOP 1%	1	2	0	0	0	3
TJTC	1	1	1	1	1	5
Research	10	8	7	6	5	36
PAYSOP	0	0	2	3	4	9
Total	22	32	26	24	20	124

1985 tax liability	76
Credits allowed:	
Research	36
General business credit	34
Total credits allowed	70
Net tax	6

Notes:

1) In 1985 the research credit was not part of the general business credit; it had its own limitation.

2) The $34 of general business credit is made up of the full $12 of 1981 credit, the full $21 of 1982 regular ITC, and $1 of 1982 TRASOP credit. The other $1 of 1982 TRASOP credit, the $1 of 1982 TJTC and the full general business credits from 1983-1985 remain as carryovers.

Example 3

Credits earned & carried forward to 1987:

	1981	1982	1983	1984	1985	1986	1987	Total
Regular ITC	20	18	16	14	10	4	2	84
Reduced ITC	17	15	13	12	8	3	2	70
TRASOP 1%	2	2	0	0	0	0	0	4
TJTC	1	1	1	1	1	1	1	7
Research	10	8	7	6	5	7	10	53
PAYSOP	0	0	2	3	4	0	0	9
Total	30	26	23	22	18	11	13	143

1987 regular tax liability	200
1987 tentative minimum tax	104
Section 38(c)(1) limitation	
(1) Sec. 38(c)(1)(A) limitation	150
(2) Sec. 38(c)(1)(B) limitation	96
(3) Sec. 38(c)(1) limitation (lesser of (1) or (2))	96
Section 38(c)(3) addition	
(4) Regular ITC (17.5% reduction)	70
(5) Sec. 38(c)(1) limitation (line (3))	96
(6) General Business credit available other than regular ITC	73
(7) Line (5) less line (6)	23
(8) Line (4) less line (7)	47
(9) 25% of 1987 tentative minimum tax	26
(10) Sec. 38(c)(3)(A) addition (lesser of (8) or (9))	26
Revised section 38(c)(1) limitation	
(11) Revised Sec. 38(c)(1)(B) limitation (line (2) + line (10))	122
(12) Revised Sec. 38(c)(1) limitation (lesser of (1) or (11))	122
Regular tax liability	200
General business credit	122
Net tax	78

Notes:

1) Taxpayer is a calendar-year taxpayer.
2) The calculation of the credit limitation uses the proposed rules of S. 1350.
3) The $122 credit is made up of the full $30 of 1981 credit, the full $26 of 1982 credit, the full $23 of 1983 credit, the full $22 of 1984 credit, the full $18 of 1985 credit, and the full $3 of 1986 regular ITC. These numbers reflect the 17.5% reduction for regular ITC for each year.
4) The carryover to 1988 would be made up of $1 of 1986 TJTC, $7 of 1986 research credit and the full $13 of 1987 credit. (The reduction of 1987 regular ITC is lost in the rounding.)

Example 4

Credits earned & carried forward to 1987:

	1981	1982	1983	1984	1985	1986	1987	Total
Regular ITC	23	18	25	14	10	4	3	97
Reduced ITC	19	15	21	12	8	3	2	80
TRASOP 1%	2	2	0	0	0	0	0	4
TJTC	1	1	1	1	1	1	1	7
Research	6	3	4	3	2	2	1	21
Win Credit	4	0	0	0	0	0	0	4
PAYSOP	0	0	4	3	4	0	0	11
Total	32	21	30	19	15	6	4	127

1987 regular tax liability	160
1987 tentative minimum tax	104
Section 38(c)(1) limitation	
(1) Sec. 38(c)(1)(A) limitation	120
(2) Sec. 38(c)(1)(B) limitation	56
(3) Sec. 38(c)(1) limitation (lesser of (1) or (2))	56
Section 38(c)(3) addition	
(4) Regular ITC (17.5% reduction)	80
(5) Sec. 38(c)(1) limitation (line (3))	56
(6) General Business credit available other than regular ITC	47
(7) Line (5) less line (6)	9
(8) Line (4) less line (7)	71
(9) 25% of 1987 tentative minimum tax	26
(10) Sec. 38(c)(3)(A) addition (lesser of (8) or (9))	26
Revised section 38(c)(1) limitation	
(11) Revised Sec. 38(c)(1)(B) limitation (line (2) + line (10))	82
(12) Revised Sec. 38(c)(1) limitation (lesser of (1) or (11))	82
Regular tax liability	160
General business credit	82
Net tax	78

Notes:

1) Taxpayer is a calendar-year taxpayer.
2) The calculation of the credit limitation uses the proposed rules of S. 1350.
3) The $82 credit is made up of the full $32 from 1981, the full $21 from 1982, and $29 from 1983. The $29 from 1983 is used in the following order: first, the full $21 of regular ITC; second, the full $1 of TJTC; third, the full $4 of research credit; and fourth, $3 of the $4 of PAYSOP credit. Since the PAYSOP credit is not listed in section 38(b) in 1987, it is used after the credits which are listed. The ITC used reflects the 17.5% reduction for each year.

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July 1, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, D.C. 20510

Dear Ms. Wilcox:

I was sorely disappointed to learn that the recently introduced Technical Corrections Act of 1987 (H.R. 2636) failed to clarify that charitable gift annuities are not "commercial-type insurance" under IRS Sec. 501 (m). It is very important to this University, as it is to all 501(c)(3) organizations, that the Technical Corrections Act be amended in that fashion.

I am asking your support on this issue because this stance is logical, fair and practical. Gift annuities have been an integral part of Wittenberg's development operation for many years. The failure of this Congress to amend H.R. 2636 would have a severe impact on Wittenberg and its ability to fulfill its mission.

Our rationale for this amendment is straightforward: gift annuities enable smaller donors to contribute to the University in the same way that larger donors contribute through charitable remainder annuity trusts. We in no way compete with commercial annuities, and this traditional method of giving is a very important part of our overall fund-raising effort.

I strongly urge that you help amend the Technical Corrections Act of 1987 to clarify that charitable gift annuities are not subject to IRS Sec. 501(m).

Thank you for your consideration.

Cordially,

William A. Kinnison
President

WAK:ph

Word of Life Fellowship, Inc.
Reaching Youth with the Gospel of Christ

Jack Wyrtzen, Founder, Director
Harry Bollback, George Theis, Co-Directors

Schroon Lake, New York 12870
Phone: 518/532-7111

July 17, 1987

Ms. Laura Wilcox
U.S. Senate Committee on Finance
S.D. 205
Washington, DC 20510

Dear Ms. Wilcox:

I am writing to you on behalf of WORD OF LIFE Fellowship, Inc. to express our deep concern over the potential taxation of charitable gift annuities.

Please amend Technical Corrections Act of 1987 (H.R. 2636) to clarify that charitable gift annuities issued by IRC Sec. 501(c)(3) organizations are not "commercial-type insurance" under IRC Sec. 501(m).

We believe that if we were unable to obtain relief in this area, an important source of funds would be eliminated for our charitable activities. Gift annuities have been used in organizations like ours for over 100 years. For the small donor, a charitable gift annuity is the equivalent of the charitable remainder annuity trust for the large donor, which is unaffected by Sec. 501(m). Gift annuities are used because an interested donor wants to make a gift to help a charity, not so that the donor can obtain annuity payments. Gift annuities don't compete with commercial annuities and are not "commercial-type insurance."

We would appreciate very much your leadership in clarifying the exemption of charitable gift annuities from IRC Sec. 501(m).

Thank-you.

Very truly yours,

Douglas H. Mieras

Douglas H. Mieras, CPA
Administrator

DHM:ak

LAW OFFICES

ZUCKERT, SCOUTT, RASENBERGER & JOHNSON

The Hon. Max Baucus
Chairman
Subcommittee on Taxation
& Debt Management
Committee on Finance
United States Senate
Washington, D.C.

Dear Senator:

In accordance with the your announcement June 30 concerning forthcoming hearings on S.1350, we submit the following comments on behalf of The Continental Corporation and The Chubb Corporation concerning the Technical Corrections Act of 1987.

Our comments are confined to the foreign tax provisions in Part XII of the bill, specifically Part C, U.S. Taxation of Income Earned Through Foreign Corporations, and more particularly U.S. taxation of income earned by a bona fide foreign insurance affiliate located in a high tax nation.

REAFFIRMATION OF INSURANCE TAX REFORMS

From the earliest proposals until final passage of the Tax Reform Act of 1986, we encouraged reform of U.S. insurance taxation. Removal of tax shelter opportunities from property-casualty insurance will result in more stability and availability for American consumers.

Bona fide property-casualty insurance companies are unique taxpayers. The Treasury, the Internal Revenue Service and the federal courts have long distinguished legitimate property-casualty insurance companies from other taxpayers on the basis of risk shifting and distribution. A bona fide property-casualty insurer is permitted for federal income tax purposes to use accounting methods denied other taxpayers because the unrelated insured transfers all risk to the insurer, and the insurer in turn distributes the assumed risk over a wide variety of policyholders. See Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir. 1981); Rev. Rul. 77-316, 1977-2 C.B. 53.

Property-casualty insurance investment income is not "passive interest-type income" separate and apart from basic insurance operations. Investment income is integral to the ability of an insurer to pay claims. It is considered in pricing the policy. The insurer's cost of fulfilling its obligation to policyholders is never fully funded through premium payments.

Congress has recognized consistently that taxable income of a property-casualty insurer reflects aggregate underwriting and investment results. The 1986 reforms seek to measure property-casualty taxable income more accurately under the fundamental premise that insurance income is a function of combined underwriting and investment results. The integrity of this system must be preserved. Neither the Treasury, nor consumers, nor bona fide insurance underwriters benefit when the basic tenets of insurance taxation are abused or transferred for tax shelter purposes.

CONGRESS INTENDED FOR A HIGH TAX EXCEPTION TO BE AVAILABLE FOR BONA FIDE AMERICAN INSURERS.

Under the 1986 Subpart F revisions virtually all insurance income of a foreign insurance affiliate is attributed back to the American insurance parent and taxed currently. Imputed income is calculated under Subchapter L as if the foreign insurance affiliate were a U.S. insurance company. By revising Subpart F, Congress wanted to end the practice of using tax haven or low tax countries to shield U.S. income from U.S. tax. At the same time Congress intended to protect the operations of bona fide U.S. companies in high tax nations. Congress believed that Subpart F would "impose current tax only on income of controlled foreign . . . insurance companies that is in fact received in low-tax jurisdictions."[1]

Congress enacted Section 954(b)(4)[2] to shield companies operating in high tax countries from current tax. On its face Section 954(b)(4) appears to work. However, the unforeseen interplay between new Subpart F foreign insurance reforms, new Subchapter L domestic insurance reforms, and existing foreign insurance tax systems takes away the Section 954(b)(4) exception Congress thought it had provided for American insurers with bona fide foreign affiliates in high tax nations.

SECTION 954(b)(4) DOES NOT WORK

The 954(b)(4) exception does not work for a U.S. foreign insurance affiliate because the new U.S. insurance tax base is now fundamentally different from any foreign insurance tax base. Before 1986 all major trading nations, including the U.S., based taxation of property-casualty insurers on regulatory accounting.

The new U.S. system now discounts premium reserves and taxes a portion of tax-exempt investment income. At the same time the new U.S. system accelerates recognition of premium income. In effect income is increased and deductions are decreased, resulting in a higher tax base.

Other major trading nations adhere to traditional property-casualty taxation. Consequently, the 954(b)(4) exception will never work for any U.S. property casualty insurance company--even those operating in jurisdictions with statutory tax rates higher than the U.S. rate.

THE "SAME-COUNTRY" EXCEPTION DOES NOT WORK

Section 953 provides an exception for income from insuring unrelated risks within the country in which the foreign insurance affiliate is incorporated. This approach does not recognize the global nature of property-casualty insurance. The business of international insurance is not confined to one country. In order to compete, U.S. insurers must cover multinational insureds around the world. It is necessary to write international coverage out of a country such as England to cover non-English risks due to the network of tax and trade barriers other nations erect against U.S. insurers. The London market is also the leading source for underwriting international risks from all over the world. "Same-country" risks are a minuscule portion of the insurance underwritten in London. The "same-country exception" does not recognize the business realities of the international insurance market.

PUNITIVE TAX IMPACT

Two examples illustrate the punitive tax impact and competitive disadvantage that result from the failure of U.S. foreign affiliates to qualify for the 954(b)(4) exception. The examples are based on 1986 actual operating results of 100% owned foreign affiliates of a leading U.S. property-casualty insurer.3/

1. Nondomiciled Risks

Company A is organized in the United Kingdom (U.K.) and writes international reinsurance in conjunction with the Lloyd's market in London. It writes no U.K. risks. Lloyd's is the largest single market in the world for international commercial coverage. Company A's entire taxable income from both underwriting and investments, as measured under the new Subchapter L for U.S. property-casualty insurers, will be currently taxed to its U.S. parent. As a result, this bona fide U.K. affiliate will generate a U.S. tax liability of between $5.3 and $5.5 million to its U.S. parent even though U.K. taxes paid by that subsidiary were only $300,000. Any non-U.S. owned insurer of international risks in the London market would pay only $300,000 in worldwide tax on identical operating results.

2. Domiciled Risks

Even where same-country underwriting income will not be taxable to the U.S. parent, insurance investment income remains subject to current taxation. For most property-casualty companies, investment income is the only source of profits. Underwriting income is almost always negative.

Company B is a Canadian subsidiary. When the tax base for the Canadian affiliate is recalculated under new Subpart F, the U.S. parent will incur from $700,000 to $2.0 million of U.S. tax in addition to the $2.05 million of Canadian tax incurred by Company B. Any non-U.S. owned Canadian insurer will not pay the additional $2.05 million. This result occurs under Subpart F even though the Canadian statutory rate exceeds 50 percent.

TRANSITION RULE

Section 1221(g)(3) of the Tax Reform Act of 1986, as modified by the Technical Corrections Act of 1987, grants the two largest American international insurers relief from the full impact of all foreign insurance tax reforms in Subpart F during the first three years the law is effective. Clearly transitional relief is appropriate. It is difficult to understand, however, why relief is given to the largest American international insurers, but a technical correction is not included to make the high rate exception work for the third and fourth largest American international insurers. The smaller companies will bear the full burden of paying new Subpart F taxes during the first three years the law is effective.

A TECHNICAL CORRECTION IS REQUIRED

In order to make the 954(b)(4) exception available for bona fide foreign insurance affiliates a technical correction is required. The technical correction would be available only to bona fide foreign insurance affiliates operating in high insurance tax nations. The technical correction would provide for a three year transition period. After three years the Secretary of the Treasury would be granted authority to designate high insurance tax nations using narrowly defined criteria that will adjust for differences as they change in new U.S. insurance tax law and existing foreign insurance tax law. The correction will only apply to qualified bona fide insurance companies operating in high insurance tax nations. An anti-avoidance provision will be included. If other high tax nations adopt insurance tax reforms, the Secretary will be able to reflect this in the list of designated nations. Canada is now exploring reform of its insurance tax laws.

U.S. TAX POLICY FAVORS FOREIGN INSURERS OVER AMERICAN INSURERS

American foreign insurance affiliates must compete for overseas business with established foreign companies. Foreign insurers are taxed only on foreign tax bases which rest upon regulatory accounting principles. Only the new U.S. property-casualty reforms depart significantly from regulatory accounting principles in measuring taxable income.

The competitive problem arises overseas from applying the new U.S. domestic insurance reforms to foreign affiliates of American insurers which compete against foreign insurers taxed under regulatory accounting systems. As a result some American foreign affiliates in critical markets will pay taxes 1,800% higher than any competitor.

Inside the United States, the Treasury is willing to tax foreign insurers for U.S. tax purposes on their own foreign tax base. We have no objection to that. What is objectionable, however, is the U.S. Government's refusal to recognize vast differences in foreign high tax bases for American insurance affiliates competing overseas.

IMPORTANT FOREIGN MARKETS FOR AMERICAN INSURANCE WILL BE LOST. MANY SUPPORT STAFF JOBS WILL BE ELIMINATED INSIDE THE U.S.

A few American insurers compete in the global market against major foreign insurers domiciled in the United Kingdom, Germany, France, Italy, Japan, Switzerland, the Netherlands, and Canada. Worldwide insurance premium volume in 1984 was $498 billion dollars. Of this amount 56.5 percent was property-casualty business. The major commercial centers are the European Economic Community with $56.9 billion in property-casualty premiums; the rest of Europe, with $11.45 billion; Japan, $21.8 billion; and Canada, $8.6 billion.

Chubb and Continental have been active in international insurance markets for years. Their bona fide foreign operations are not newly hatched tax haven schemes. International operations create new jobs inside the United States. Lead underwriters and technical support staffs are located in the United States. A fully computerized global network allows Americans to provide risk analysis, status reports or other information about complex multinational risks to field staffs overseas.

International insurance has grown as rapidly as 80% during the past five years. Approximately 3,000 Chubb and Continental employees support foreign operations. New employees have been hired to support this growth. If the 954(b)(4) exception is not available, affiliates in high tax nations will be sold, resulting in a loss of 750 jobs within the United States. More important than the loss of current jobs is the removal of future economic growth for American insurers which will benefit our entire economy.

If the excessive taxation of American insurers' bona fide foreign affiliate income from high tax nations is not reversed, international insurance premiums will be lost to foreign competitors. The Harvard Business Review noted recently that

U.S. service industries, including insurance, could follow American manufacturing into decline. Net positive trade balances in services have fallen steadily since the beginning of the decade -- from $41 billion in 1981 to $21.4 billion in 1985. See James B. Quinn and Christopher E. Gagrion, "Will services follow manufacturing into decline?" Harvard Business Review, Nov-Dec. 1986.

THE TECHNICAL CORRECTION IS IN ACCORD WITH GATT AND OTHER U.S. LAWS.

The General Agreement on Tariffs and Trade ("GATT") is designed to keep nations from pursuing national trade policies harmful to other nations and the world economy as a whole. The "Most-Favored-Nation" and "National Treatment on Internal Taxation and Regulation" clauses aim at breaking down trade barriers.

The technical correction would create no barriers to trade nor give U.S. companies any advantage not extended to foreign insurers. The technical correction would merely put American insurers in a competitive position with foreign insurers in foreign markets. This is in accordance with GATT goals. The U.S. already accords foreign insurers a more favorable tax status inside the U.S. than it provides for American insurers.

The fact the technical correction names specific countries for its purposes does not violate GATT. So long as the purposes of the GATT agreements are effectuated a nation may adopt its laws in any form it chooses.

Other provisions of the Internal Revenue Code list countries by name. Section 1201(e)(2)(H) of the Tax Reform Act defines "qualified loans" for the foreign tax credit as loans made to one of thirty-three specified countries or the residents thereof. I.R.C. § 999 requires the IRS to issue a list of countries that may require participation in, or cooperation with an international boycott. See also Notice 87-40, 1987-23 I.R.B. 13. (list of § 999 countries). The proposed technical correction would be in accordance with GATT and would follow a well-established format in the Internal Revenue Code.

NO REVENUE IMPACT

Congress enacted the high effective rate exception in Section 954(b)(4) with the intent that American businesses conducting bona fide operations in high tax nations would not be subject to Subpart F reforms designed to raise revenue from operations in tax haven or low tax nations. No revenue was intended to be raised under Section 954(b)(4).

The data used by the Joint Committee to estimate revenue under Subchapter L and under Subpart F from American insurers did not include income from foreign insurance affiliates in high tax nations. Consequently a technical correction will have no negative impact upon insurance revenue estimates provided Congress under the Tax Reform Act of 1986.

If the Section 954(b)(4) exception continues to be unavailable for American insurers, and if American insurers continue to operate their affiliates in high tax nations as they now do, less than $50 million in revenue will be collected.

Without the Section 954(b)(4) exception, bona fide foreign affiliates will be subject to a tax increase of 1,800%. No other foreign or domestic competitors will be so affected. Competition under such a punitive tax structure will be impossible. The result will be outright sales of bona fide foreign affiliates of American insurers in high tax nations to foreign insurers. The source of all future income will no longer be owned by Americans.

We would be pleased to provide the Committee with any additional information which would be helpful.

Sincerely yours,

Walter Vinyard

Walter D. Vinyard, Jr.

WDV,jr./j

1/ H. Rep. No. 426, 99th Cong., 1st. Sess. pgs. 398-399 (emphasis added).

2/ I.R.C. § 954(b)(4) provides an exception for companies operating in a high tax country. Under Section 954(b)(4) Subpart F income does not include income that was subject to an effective rate of tax in the foreign jurisdiction greater than 90 percent of the U.S. tax rate.

3/ For some of these companies, no foreign tax credit ("FTC") is available because the foreign insurance affiliate is more than a third-tier subsidiary. See § 960(a). For other companies, the FTC is available. Consequently, each example will show the additional U.S. tax burden assuming first full creditability and then zero creditability.

ZUCKERT, SCOUTT, RASENBERGER & JOHNSON

Supplemental Sheet

Designated Representative

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Summary of Comments

Technical Correction

TO CLARIFY THAT THE SECTION 954(b)(4) EXCEPTION IS AVAILABLE AS CONGRESS INTENDED TO QUALIFED FOREIGN INSURERS OPERATING IN HIGH TAX COUNTRIES

REAFFIRMATION OF INSURANCE TAX REFORMS

CONGRESS INTENDED FOR A HIGH TAX EXCEPTION TO BE AVAILABLE FOR BONA FIDE AMERICAN INSURERS

SECTION 954(b)(4) DOES NOT WORK

THE "SAME COUNTRY" EXCEPTION DOES NOT WORK

PUNITIVE TAX IMPACT

TRANSITION RULE

A TECHNICAL CORRECTION IS REQUIRED

U.S. TAX POLICY FAVORS FOREIGN INSURERS OVER AMERICAN INSURERS

IMPORTANT FOREIGNMARKETS FOR AMERICAN INSURANCE WILL BE LOST. MANY SUPPORT STAFF JOBS WILL BE ELIMINATED INSIDE THE U.S.

THE TECHNICAL CORRECTION IS IN ACCORD WITH GATT AND OTHER U.S. LAWS

NO REVENUE IMPACT

United States Council for International Business

Serving American Business as U.S. Affiliate of

The International Chamber of Commerce
The International Organisation of Employers
The Business and Industry Advisory Committee to the OECD
The ATA Carnet System

July 21, 1987

Dear Mr. Chairman:

Oh behalf of the United States Council for International Business, we are pleased to respond to your request for comments on the pending Technical Corrections Bill (S. 1350). The United States Council for International Business is comprised of some 300 major corporations, law firms, and accounting firms with substantial experience in foreign operations of U.S. entities. The Council represents American business in the major international economic institutions such as the OECD and the International Chamber of Commerce.

We are concerned about action proposed to be taken with respect to the interaction of provisions of the Internal Revenue Code and obligations under U.S. income tax treaties with other nations, including statements in the explanation of the bill that suggest an abandonment of long standing principles governing U.S. compliance with treaties.

We do not believe that changes in U.S. commitments to international agreements should be considered as mere technical corrections. We refer specifically to proposed legislation affecting presumptions as to whether inconsistent treaty or statutory rules should prevail; the overriding of existing treaty provisions in possible future conflicts that have not been identified; and the interpretations of treaty nondiscrimination provisions that could, if adopted by others, significantly undercut treaty protection for U.S. companies and their subsidiaries against discriminatory tax laws of foreign countries. We propose, therefore, that section 112(y) (Coordination with Treaties) be deleted from the bill.

Very truly yours,

Richard M. Hammer

Richard M. Hammer
Chairman
Committee on Taxation

Robert J. Patrick, Jr.

Robert J. Patrick, Jr.
Vice Chairman
Committee on Taxation

cc: Honorable James A. Baker, III
Honorable J. Roger Mentz

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