EXECUTIVE COMMITTEE MEETING ON PROPOSED TAX REFORM ACT OF 1986

MONDAY, APRIL 14, 1986

Committee on Finance

Washington, D.C.

The committee met, pursuant to recess, at 9:30 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Heinz, Wallop, Symms, Grassley, Long, Bentsen, Matsunaga, Moynihan, Baucus, Boren, Bradley, Mitchell and Pryor.

Also present: Richard Darman, Deputy Secretary of the Treasury; Roger Mentz, Assistant Secretary for Tax Policy, Department of the Treasury; Steve Shay, International Trade Counsel, Department of the Treasury; Dennis Ross, Tax Legislative Counsel, Department of the Treasury.

Also present: Bill Diefenderfer, Chief of Staff; David Brockway, Chief of Staff, Joint Committee on Taxation; Randy Weiss, Deputy Chief of Staff, Joint Committee on Taxation; John Colvin, Chief Counsel; Bill Wilkins, Minority Chief Counsel; Mary Frances Pearson, Tax Counsel, Majority; Lindy Paull, Tax Counsel, Majority; Greg Jenner, Tax Counsel, Majority; Paul Strella, Tax Counsel, Majority; Pat Oglesby, Joint Committee on Taxation; Barbara Groves, Tax Counsel, Minority; and Susan Taylor, Executive Assistant.

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The Chairman. The hearing will come to order, please.

This morning, we are going to have an explanation of the foreign tax provisions in the bill. And then this afternoon at 1:30, we will take up for votes employee benefits, accounting, depreciation. There are still some amendments left on those. And one or two members who cannot be here have asked to reserve their right to bring up an amendment later on. But we will not come back to those sections until significantly later on.

Before the morning is out, I will have a list for the members of the hearing dates or hearing times for the next three weeks, and at least the list we will take up morning and afternoon this week, plus what I hope to be the order that we will be able to take up matters next week. But there may be some change in the order, depending upon member wishes or member attendance.

Now let us start. Are you ready, Mary Frances?

Ms. Pearson. Yes.

The Chairman. Do you have that chart?

Ms. Pearson. Yes, I do. Right here.

The Chairman. And the members have it or do they have it?

Ms. Pearson. Curtis will pass it out.

The Chairman. Thank you.

Mary Frances prepared a chart. You can take a look at it. It finally on one simple page made it understandable as to what the foreign tax credit is and why it is so important and why businesses want to do certain things or not do certain things with it.

Basically, it is a very simple formula. And you can pass that out to the press table, if you want, Curtis.

It is a very simple formula that shows how it works and why the foreign tax credit is higher or lower, depending upon whether income and expenses are sourced in the United States or sourced overseas.

I know before we start this morning Secretary Mentz wants to make a few comments. And, Roger, could I call on you now?

Mr. Mentz. Yes. Thanks, Mr. Chairman.

I would just like to observe that in several instances both in the House-passed bill and in the Chairman's proposal there are provisions that would override existing income tax conventions. That is, bilateral conventions that the United States has with other countries.

Under our legal system, it is possible to have a statutory override of an existing treaty provision. However, that type of statutory provision tends to cause us serious problems with our treaty partners. They tend to think of us as not reliable and not basically honoring our commitments.

So I would just make the general observation that to the extent possible, and when we come to specifics, I will mention them, but to the extent possible we should try to avoid adopting statutory provisions that conflict with our income tax convention.

The Chairman. Did the Administration have any recommendations that would have violated treaties?

Mr. Mentz. Basically, our provisions would not, except in the case of the dividend-paid deduction which had a delayed effective date. And the theory of that was that the conventions could be renegotiated in order to take that into account.

And that is a possible middle ground, I might say. But as we go through, I think we will pick these up.

The Chairman. All right.

Are you ready, Mary Frances?

Ms. Pearson. Yes.

The Chairman. You are starting on, what, Page 82?

Ms. Pearson. We are starting on Page 82 with foreign tax credits.

I would like to give a brief overview, though, Senator Packwood. On this two-paged outline talking about the foreign tax credit, I want to point out that this is the formula taxpayers use to determine what their foreign tax credit limitation is and how much foreign tax they can take.

The reason that taxpayers are very concerned about the President's proposal and the House proposal is that it reduces this foreign source income on this formula. It reduces it.

And when this foreign source income is reduced, it lowers the foreign tax credit. Therefore, we got arguments that this would hurt international competitiveness.

The Chairman. Is it fair to say that both the initial Administration position and the House bill did everything they could to attempt to source expenses overseas and income here?

Ms. Pearson. Right.

The foreign tax credit in the Chairman's proposal does not adopt the Administration's per country provision. Therefore, we allow the averaging of income on the first page here in this formula.

It also does not adopt some of the House's separate baskets, which, again, would have reduced this foreign source income numerator.

We expand present law separate limitations for passive income because that is the type of income which can be easily moved here and abroad.

And moving onto Page 83, for credits -- for taxes in lieu of income taxes, we adopt the House proposal that creates a separate foreign tax credit for high taxes paid on bank interest.

Page 80 --

The Chairman. Mr. Secretary, you butt in when you want to comment.

Mr. Mentz. All right. Well, in that case, I will butt in right now.

I would just like to clarify a bit or maybe elaborate on the policies behind the foreign tax credit limitations.

The purpose of the foreign tax credit is to eliminate double taxation. If there is income taxed in a foreign jurisdiction and the U.S. also taxes that income, the credit provides a mechanism so that that income isn't taxed twice. It provides a mechanism for avoiding international double taxation of the same income.

The purpose of the foreign tax credit limitation is to ensure that the credit is only available against foreign source income. If you didn't have a limitation but only a credit, it would be possible for taxpayers to take a foreign tax credit against U.S. tax that would otherwise be payable on U.S. income so that, in effect, a company with international operations would have a U.S. tax benefit, a lower tax on its U.S. income, than would a company that was simply operating domestically.

So I think that it isn't quite right to say that the President tried to do everything possible to lower the numerator of the foreign tax credit limitation nor did the House.

I think what we are trying to do and the object of the exercise is to accurately measure, measure accurately, the foreign source net income because if that is done precisely the way the foreign tax credit limitation works is it is a taxpayer's effective tax rate times its foreign source income. That is really what the credit means.

So that if you measure foreign source net income correctly, the credit will work correctly, the limitation will work correctly.

Now the changes that the President recommended in terms of source rules and some of the other rules were intended to try to measure more correctly that numerator.

I think that a number of the provisions that the Chairman has come up with are, indeed, improvements and simplification. It is fair to say that a per country limitation, whatever its theoretical justification, is simply just too difficult as a practical manner to manage. And although the President proposed it, you won't find the Administration supporting it any further.

So in many respects the Administration is supportive of the -- some at least or many at least of the provisions in the Chairman's package.

I don't know how you would like to proceed, Mr. Chairman. I do have some observations on the credit in lieu of income taxes, which is a very important one to the Administration.

Do you want me to go into those now? Or however you want to proceed.

The Chairman. Why don't you go into them now?

Mr. Mentz. All right.

This is known as the cross border loan issue. And what occurs under current law is perfectly legal. There is nothing wrong with it. A U.S. taxpayer and normally a bank makes a loan in a jurisdiction in which it does not do business. And that -- the interest on that loan is subject to withholding tax impoved by the foreign jurisdiction.

Typically, that withholding tax is on a gross basis, maybe 30 percent, which is the same as the U.S. withholding tax rate. And normally that is going to be a tax that is greater than the net profit on that loan.

The effect of that is it is -- if the taxpayer and bank typically are able to utilize that excess credit against other low-tax foreign source income, the effect of that is a better deal than complete exemption of the income.

In other words, if the U.S. tax system just said we won't tax that income at all, that would be not as desirable a result as is under current law. The taxpayers who have been doing this, have been making the cross border loans, are fully in compliance with current law. There is no cheating; there is no tax avoidance; there is nothing at all improper about it.

The House came up with a proposal to cut this back. And the Chairman has done the same thing. Basically, there would be under the Chairman's proposal a limitation so that foreign withholding taxes in excess of, I guess, five percent or greater -- and there is a significant difference there whether it is more than five percent or five percent or greater.

But the Chairman's package is five percent or more. They fall into a separate limitation. And, effectively, they cannot be used against income from other sources that would typically be low tax income so that they could be absorbed.

While we think there is a good bit of merit in that because that proposal basically provides treatment that is the equivalent of exemption of that income, no better, no worse -- under current law, it is a little better than -- it is substantially better than exemption -- should cut it back to exemption.

We have some concerns about the transition, the transition from current law to this treatment as proposed. And, indeed, those concerns are echoed by the Federal Reserve. Chairman Volcker has expressed concerns about how you get from the present system to the new system.

And we have been working with the Chairman's staff and, indeed, we have a letter from him just this morning which, I think, I believe, is being passed out to members of the Committee.

Perhaps I should explain where the staff discussions have led us. They have basically led us to agreement with the Chairman's proposal with a more generous grandfather.

And the grandfather would be along the following lines. For loans other than to less developed countries. In other words, a cross border loan to a developed country. Whatever the status of the loan on September 25, 1985, the taxpayer would have 10 years to retain that loan and would get full credit for the amount of foreign taxes withheld that he could use, that it could use, against other income. After 10 years, that would be the end of the grandfather.

For the so-called Baker 15, the less developed countries, for those jurisdictions, the taxpayer could rearrange any loans within the 15 countries anyway it wanted -- shift into Mexico, out of Mexico to Peru or Venezuela. And the amount of the credit would increase three percent per year so that there would be really a very liberal treatment of those 15 countries.

And after the three-year period expires, there would still be the remaining seven years of a grandfather so that those credits would still be available against non-separate basket income. And that would go on for the remaining seven years.

That provision, basically, provides a smooth transition into what we believe is really a very reasonable provision.

And, incidentally, Mr. Chairman, to give you an idea as to where that would bring us internationally, it would take us from being one of the most generous, if not the most generous, countries in terms of allowance of foreign tax credits for cross border loans. It would bring us back toward the middle of the pack.

It would leave England and Japan more generous. It would have countries such as Germany, France and Switzerland either the same or less generous.

And, again, I think the important issue here is transition. And I believe -- I trust you all now have the Volcker letter, which indicates basic agreement with this suggestion that I have just outlined.

Senator Symms. Mr. Chairman, could I ask the Secretary a question. Oh, excuse me. Go ahead, Senator, if you want to.

Senator Bentsen. Mr. Secretary, as I understand it then, what you are doing, we were doing in this country, was to give a credit on the gross tax of a foreign country that was more than was necessary to offset the tax on the net income in this country.

Mr. Mentz. That's right. In other words, the income that is received from cross border loan is exempt. And, effectively, you have got the excess credit to be used somewhere else.

Now those loans were priced, and they were bid, based on that economic assumption. And that is the reason --

Senator Bentsen. That is why you need the transition period.

Mr. Mentz. That is why you need the transition. That is right.

The Chairman. Steve.

Senator Symms. Thanks, Mr. Chairman.

Mr. Secretary, what -- if we are going to pull back some of the tax incentives for people that work and do business overseas, what do you estimate the behavior changes will be?

Mr. Mentz. I think that the behavioral changes will be that, first of all, in the less developed countries I think the behavioral change will not -- behavior will not change at least for the first three years. But in the developed countries where there is not the three percent increase, there will be pressure on the foreign governments to reduce their withholding taxes. But to the extent that they are not reduced, there will be some shifting of cross border lending by U.S. lenders away from those countries and probably into other countries. There will be a realignment.

But I don't think we foresee any major curtailment of foreign lending or major impact on exports or what have you.

Senator Symms. Let me ask a more specific question. How about a construction company that does a lot of work overseas? How would it impact them? Like Morris and Kunutzson, to be specific? And will they hire as many people from the

United States to work overseas or are they going to be forced to hire foreigners?

Mr. Mentz. I don't know why it would affect a construction company. It certainly wouldn't affect them directly, Senator Symms.

The only effect that I could see is if they were getting their financing from a bank, from a U.S. bank, that wasn't doing business in that jurisdiction. And, typically, where you have a U.S. firm that -- like the one you described -- is fully engaged in business, really in place in a foreign country, they would typically have many sources of financing available to them, including local finance.

So I don't see that particular case as being one that would be impacted.

Senator Symms. Any impact on the employees?

Mr. Mentz. No, I don't think so. Not in that kind of a case. I think the only -- no, I guess I stand by that answer. I don't see it in that case.

Do you, David?

Mr. Brockway. I should think, if I understand the hypothetical, that an effect would be marginal. Almost all these loans are loans to foreign governments or just foreign persons. And I think hypothetically you are talking about a loan to a customer of a U.S. company.

I think the Secretary's statement is correct that generally you shouldn't have any significant impact there.

Senator Symms. Thank you, Mr. Chairman.

The Chairman. Senator Moynihan.

Senator Moynihan. Mr. Chairman, I have to say that I really am puzzled by this provision. And it seems to me to put American banks at a very precise and quantifiable disadvantage with competing with lenders -- U.K. and the FRG. Simply that money is money and is it loaned at a rate of interest and that interest expects a greater return.

It is the standard practice for the major banking countries to allow banks to average. I mean to average their foreign tax rate and charge that as a credit against their domestic taxes.

And to the degree that the United States banks cannot do that, they become less competitive on just the pricing of loans in a world market where there are competitors.

And, secondly, we have been talking here last week at great length about organizing our depreciation schedule such as to encourage productivity oriented investments in terms of international competition.

Well, it is, I believe, a fact -- and Mr. Mentz -- that a very high proportion of cross border loans finance the purchase of American products. A number of banks I spoke with earlier.

And, finally, Secretary Baker has made a very strong initiative, the Baker initiative, to get loans to some 15 LDCs, less developed countries. And, certainly, this is not going to encourage American banks to make such loans.

Some of those countries -- I think Brazil is one -- have a particularly high rate of local taxation. I think Mexico is another.

Why are we doing this?

Mr. Mentz. Well, Senator, if I may say so, I can assure you that I wouldn't be up here advocating something that Secretary Baker didn't like. At least I would be very foolish to do so.

The Chairman. We just barely got you past this Committee.

Mr. Mentz. That is right. It was a squeaker.

(Laughter)

Senator Moynihan. Not in the second week of your incumbency.

(Laughter)

Senator Moynihan. Have you ever thought of what you could get from Harper and Row?

(Laughter)

Senator Moynihan. The real truth behind the cross border loans. Well, help us. Is it not the case?

Oh, I'm sorry.

Senator Bentsen. I thought you were through. I'm sorry.

Senator Moynihan. Is it not the case that we are putting American borrowing-lending banks at a competitive disadvantage with the Japanese, British, German? Is it not the case that most of our -- that a heavy proportion of these loans financed American exports? And is it not -- why are these loans -- the United States is encouraging loans to the particular countries that would be -- it would most affect bank earnings; that they could not stop their taxes.

Mr. Mentz. Well, as I explained perhaps before you came in, Senator Moynihan, the present system exempts the income on cross border loans and then some. It takes the excess credit and allows the lender to use it against other low tax income.

So it is better than a tax free -- it is better than muncipal bonds, basically.

Now a couple of other jurisdictions have the same policy. Japan and UK do. Germany, France and Switzerland do not. All we are suggesting, all the Chairman is suggesting, is to move the policy on cross border loans back toward the middle of the pack, back not to be at the most generous foreign tax credit position on cross border loans.

Now you asked about exports. It is true that some exports are financed by so-called cross border loans. The question occurs if a cross border loan -- if the economics change so that it is not as advantageous for you as a lender to make it, the question is does the exporter have other sources of financing. And, frequently, that is the case either through a bank in the local jurisdiction or through another bank or through financing the receivable itself and then selling it to U.S. banks.

I don't think it is fair to say that if we do this, accept the Chairman's position, that you are going to shut down exports or even have a major crimp on exports. I think it is a matter of just trying to bring our tax policy a little bit more in line with most of the rest of the world.

Senator Bentsen. Mr. Secretary, aren't you, in effect, trying to do away with an accounting feature that gives an excess credit above the net, doing it on a gross basis so the bank has more than actually it would be entitled to? And they have been using that in the bid process to set their interest rates. So, therefore, you need a transition period to accomplish that. And along with the Baker initiative, you are giving or asking for an additional transition period for third world countries. Is that correct?

Mr. Mentz. That is precisely right, Senator Bentsen.

In fact, I might mention where the five percent number comes from. The assumption is that -- kind of a rough assumption -- that after cost of funds and other expenses, if you assume that a cross border loan nets about one and a half percent, you take 35 percent of that which would be the U.S. tax under the proposed rate schedule, and you come to about five percent.

So the theory is that if the withholding rate is five percent or lower, you go ahead and allow it without limitation. If it is higher than that, you do subject it to a separate limitation.

But the short answer to your question is yes.

Senator Moynihan. Can I ask you to go through that just once again? Is this a modification you are proposing?

Mr. Mentz. No, no. This is the basic Chairman -- the only modification, Senator Moynihan, is in some transition provisions which we have had under discussion with Chairman Volcker.

Senator Moynihan. I don't think we have transition provisions in here.

The Chairman. Not in the draft as I prepared it.

Senator Moynihan. Yes. That is a pretty important transition.

Mr. Mentz. Yes. Would you like me to --

Senator Moynihan. Would you mind?

Mr. Mentz. No, not at all.

Chairman Volcker has expressed, as I think you know --

Senator Moynihan. Yes.

Mr. Mentz. -- concern about switching over and what problems there would be for banks. Now for non-less developed country loans, the idea would be those loans were made on an assumption, a fair assumption based on current U.S. law, no hanky-panky involved or anything like that, that there would be credits in excess of the net income on that loan. And those credits would be available to used against other foreign source income of the lender.

Senator Moynihan. In those countries where the tax --

Mr. Mentz. Is higher.

Senator Moynihan. -- is higher than American?

Mr. Mentz. That is right. In other words, the typical bank has cross border loans and then has other loans in countries where it is operating.

And the idea is that there would be an excess credit that would be available against other low-tax foreign source income.

Senator Moynihan. As the case may be.

Mr. Mentz. As the case may be.

The idea would be allow a 10-year rule so that any loan that is in place on, I guess, September 25, 1985 which was the date of the House -- I'm sorry. It is November 16th, which was the date of the House action.

Allow that a 10-year period to run off so that if the loan is a five-year loan, you let it five years; if it is an eight-year loan, you let it eight years. If it is a six month loan, it only gets six months. Because that is the basic economic bargain that the lender made. So you let him have the benefit of his bargain.

Senator Moynihan. In respect to this grandfather.

Mr. Mentz. It is a grandfather. That is right. But there is --

Senator Moynihan. With a 10-year limit.

Mr. Mentz. Yes. But there is a further grandfather for the so-called Baker 15. And the way that grandfather would work would be to the extent that a taxpayer has loans in any of the 15 countries -- it doesn't matter to which borrower and it doesn't matter to which country -- that taxpayer could shift to another borrower, shift to another country anyway he wants to, mix and match, within the --

Senator Moynihan. Existing law.

Mr. Mentz. -- existing law, with a limitation of the overall amount of credit plus three percent per year, which was the number picked in the House mark up for the next three years. So that for three years, a lender that is into Brazil, for instance, could clean out all the loans in Brazil and move them all and lend the same amount to Mexico or go to Venezuela or what have you.

And, basically, the credits involved in those with respect to those loans would be available without limitation. Once you get past the three-year period, then you would be under the basic 10-year grandfather and whatever the credits were on the existing loans, you take the rest of the 10-year period and let them run off.

Senator Moynihan. Mr. Shay.

Mr. Shay. Senator, I wanted to point out with respect to Chairman Volcker's comments on this proposal. He has indicated he may have further technical comments. There are just two I wanted to alert the Committee to that are under discussion with the staff that the Federal Reserve staff has some concerns about.

One is -- the first one is very technical, which would limit the extent to which lenders could use this transition rule to shift loans from very risky members of the 15 countries to less risky. In other words, while we would continue to have a very flexible rule, the Federal Reserve is concerned that the rule not be used so that lenders shift their exposure from the least credit worthy members of the 15 countries to more credit worthy.

And we are sympathetic to that as a policy matter and believe it can be worked out quite simply.

The other concern that I think underlies the last part of the Chairman's letter indicating technical comments is the Federal Reserve staff and the Chairman are somewhat concerned about a 10-year cliff on the LDC loans and would like to revisit that issue.

Those are the two points, I think, he had in mind with respect to the last part of his letter.

Thank you, Senator.

Senator Moynihan. Mr. Chairman, I wonder if I could make this comment. And perhaps we have more work to do here. But the -- what is an LDC?

Mr. Mentz. A less developed country.

Senator Moynihan. What is a less developed country?

Mr. Mentz. It is one of the 15 countries on the list.

Senator Moynihan. A debtor. I mean it is what you say it is.

Mr. Mentz. That is right.

Senator Moynihan. Yes.

Mr. Mentz. What the Secretary says.

Senator Moynihan. Well, is it Secretary Baker or Secretary Volcker?

Mr. Mentz. It is Secretary Baker.

Senator Moynihan. Secretary Baker knows an LDC when he sees one. An LDC, a country that owes more money that it is owed.

Mr. Mentz. Are you suggesting the United States may become an LDC?

Senator Moynihan. I didn't say that, but I heard it from -- an extraordinary proposition from the Assistant Secretary of the Treasury.

Yes. What is an LDC? You know what I mean. It is an arbitrary classification.

Mr. Mentz. Yes. Really, the LDC concept is one that Secretary Baker has employed in a non-tax context trying to develop a --

Senator Moynihan. That is what I mean. Probably the closest thing to a working definition of this generality is the nations that have access to the IDA at the World Bank, wouldn't you say? Is there not a list? The soft loan window at the World Bank.

Mr. Mentz. I don't know.

Senator Moynihan. And you who know a very great deal don't know the answer to this because there is none. It is a generalization we make about certain kinds of countries. And we are putting it into our tax code, Mr. Chairman. And then we are saying, well, not just any LDC, but these 15 LDCs.

Mr. Mentz. We have had LDC provisions in our tax code long ago. We used to have a different rule on how the foreign tax credit -- were being paid foreign tax credits from a foreign subsidiary. And it was computed depending upon whether you were a less developed country or whether you were not.

That went out in the mid-1970's, I believe. But it was in the law for many, many years. So a lot of distinction that is unprecedented, Senator.

Senator Wallop. We're reporting it back.

Senator Moynihan. We are reporting it back.

All right. I think we can talk about this possibility, Mr. Chairman. Obviously, you are trying to make a transition. It has got to be clear that there is some tension between Secretary Baker's desire to get more loans to precisely these countries we are now making it less advantageous to lend to. There has got to be that tension.

And I don't know why we are doing this to ourselves. I mean the Japanese aren't going to do it to themselves. Is this a very cunning three-move chess -- this is the way we are going to get the Japanese to get rid of all that surplus money by lending it to Brazil?

Mr. Mentz. No, I think we are doing it for valid tax policy reasons which basically come down to -- it is hard to find a reason to have a better tax treatment of a cross border loan than complete exemption from tax. And we are trying to get there, Senator, with the most reasonable transition provisions, particularly for the less developed countries.

And I don't think I can say it any better than that.

Senator Moynihan. Is it really a complete exemption? I guess my problem is we are trying to, at a time when the United States Government is officially trying to get more American loans to a particular set of countries that have this characteristic of taxation, at a time when we are talking about exports and international competitiveness -- and banking is certainly an aspect of both -- why are we making it more difficult for these banks?

I mean the principle of double taxation comes in here. If you have already paid the tax in one country, you are not being exempted from it because you don't have to pay it again.

The Chairman. Mr. Secretary, isn't one of the things we are trying to do -- you have got a situation where the banks are almost held harmless. If they invest overseas, you have high taxes overseas, the interest rate also reflects the risk, and they are protected by the United States Treasury on the foreign tax credit. They also have a lot of round tripping where the money hardly ever leaves here and is invested through the bank in this country. And we are simply trying to cut down what would appear to many people to be almost an abuse.

Mr. Mentz. Yes, that is right.

Senator Moynihan. One week we adopt an entire depreciation schedule on the basis of international competitiveness. And we start the next week out by saying we don't want banks to make -- when you say round tripping, that basically means financing exports, doesn't it?

The Chairman. Mary Frances?

Ms. Pearson. No, it doesn't. It means that a loan is made to a third world country, like Mexico, and the money comes back to this country to be invested tax free.

Senator Moynihan. That is your round tripping.

Ms. Pearson. That is what we mean by round tripping.

Senator Moynihan. That word, "third world," a French term, a term of ideology and art and hardly one that could have anything to do with our tax code.

The Chairman. Why don't we try to move on to the rest. I think we have pretty much massaged this for quite a while.

Senator Moynihan. Can we agree that we want to have some more -- if there are conversations going on between the Federal Reserve Bank and the staff, can some of the members of the Committee get in?

The Chairman. Absolutely.

Senator Moynihan. Thank you.

Ms. Pearson. Mr. Chairman, we are now on Page 84, the effects of losses on foreign tax credits.

We generally keep present law which -- with some clarifications. There are foreign losses. First offset foreign source income, then it offsets U.S. source income.

In the next year, if a profit is made on foreign income, foreign source income, then you have to recapture the portion of U.S. source loss.

Page 85, deemed paid credit. Again, this is a change to have earnings and profits of a foreign corporation computed in the same manner for purposes of a subpart f distribution and a deemed paid credit distribution.

Page 86, we move onto the source rules. Again, I would like to emphasize that our package, the Chairman's package, sources more income abroad to help exporters. The primary situation here is on Page 86-1. We allow the title passage rule under present law to continue where the House and the President would have sourced in this country for the most part.

Number 2, income from the manufacture and sale of inventory-type property, we keep present law again, sourcing 50 percent where the product is manufactured and 50 percent at the place of sale.

Mr. Mentz. Mr. Chairman, I would just like to break in there for a moment, if I may. The reason that the President's proposal went away from the title passage rule is that while it is a simple and straightforward rule, it is obviously one that can easily be arranged by the taxpayer so that he gets the maximum amount of foreign source income. And, indeed, where everything is going on in the United States and you simply pass title outside the United States, the effect of that, the effect of allowing, of respecting, the title passage rule is to exempt the profit -- for a corporation that is in an excess foreign tax credit position, the effect is to exempt the profit on that transaction from U.S. tax. Because were it not for that source rule, the gain would at least be partially U.S. and would be, therefore, subject to tax and not available against the limitation.

The Chairman. You had a situation where a Catepillar or a John Dere manufacturers here; sells their equipment overseas; and you are going to source all of the income here under your proposal.

Mr. Mentz. Well, if it is mere title passage -- you manufacture here, you put it on a boat, and there is no activity, no office or fixed place of business in the other jurisdiction, yeah, I think the source of the income reasonably is here.

The reason that the title passage rule is respected is because one case was decided that upheld it and we never challenged that case or never tried to write regulations that would overrule it. And the title passage rule has basically become ingrained in our tax law.

But I think it is hard to defend in the pure case where there is nothing going on overseas. In the case where there is an office participating, where there is activity, then there is no question that you have a --

The Chairman. And that is what we have tried to draw. But in fairness, if the principal activity is selling, that is still overseas activity, and you maintain some office and you make phone calls and you are in competition with Japanes tractors, I mean that is fair overseas activity.

Mr. Mentz. Even if it orginiates in the United States?

The Chairman. Well, you are attempting to sell it overseas. You have got expenses overseas. You have got personnel overseas.

Mr. Mentz. Well, if you have personnel overseas and an office overseas, then our rule would be more in think with yours. It is really the case where there is nothing overseas that --

The Chairman. Mary Frances?

Ms. Pearson. Thank you, Mr. Chairman.

Mr. Chairman, if an office is located overseas then that subject's Catepillar is foreign taxed. So not only do we not collect anymore because the foreign tax credit offset it, we now subject our companies to an extra tax burden of foreign taxes.

We are now on Page 87, income from the sale of intangible property. We sourced it in the country of residence of the seller, except if the sale involves material participation in a foreign country. Income derived from the sale of other personal property number 4, Page 87, we source recapture income where the deductions were taken. Therefore, if property had depreciation taken in this country, resourced in this country, for purposes of recapturing the tax benefit.

Page 88, transportation income. We adopt basically the

President's rule that sourced income is 50 percent in the United States and 50 percent in the --

Senator Symms. On that, I have a question.

The Chairman. Go ahead, Senator.

Senator Symms. The question is: If I understand it correctly, since 1921 until present, you call the ship from the flag that it flies. Is that correct?

Ms. Pearson. Yes.

Senator Symms. But in this rule you are trying to establish the residence of the owner? Is this the area that we are --

Ms. Pearson. Yes. We are almost there. The reciprocal exemption, if a foreign flag country grants an exemption to our U.S. flag companies from a growth withholding tax, we will not impose our growth withholding tax.

Now -- does that answer your question, Senator?

Senator Symms. I guess the question is: How much revenue does this proposal raise? And how much more confusion and complication of administrative problems will it create? And then what will the impact be on both domestic and foreign shipping?

Ms. Pearson. Well, we raise $600 million over fiscal years 1986 to 1991. I will let Treasury answer the compliance problem.

Senator Symms. That is what I have been told. That the compliance problem will be very difficult, and the additional-- you know, there are some countries, I understand, that Treasury feels have been out of compliance, but most of the countries have not been abusing this. Is that correct?

Ms. Pearson. Our four percent tax, we will require them to show that in order not to pay the four percent tax -- we will require them to show that they are entitled to the exemption.

I in my years with the IRS have always found that if foreign taxpayers or U.S. taxpayers want to get out of paying a tax, they will come forward and prove it. But I will let Treasury comment on that point.

Senator Symms. Let me get a little more specific, and then I would like to hear from Treasury.

I have been told that India and Pakistan are the areas where the problem is. But this proposal just makes a broad brush approach to the whole problem, and it is going to be very difficult to comply with and very confusing and cause a lot of chaos in shipping. And I wonder if somebody would comment on this.

And what I am wondering is if this is worth all the hassle.

Mr. Shay. Senator, if I could comment. You are correct that those two countries each impose a gross tax on shipping. It has been a subject of great concern to U.S. shippers.

And one of the effects of the Chairman's package is to reduce the scope of the four percent tax that is proposed from applying it to all countries subject to exemption to only those countries that themselves impose the gross tax on shipping on our shippers.

So that has narrowed the scope of this provision significantly. And I might add that was done in response to comments from various shipping interests.

As to the broader question of compliance, your initial comment reflected that the proposal would shift what is currently the reciprocal exemption which is based on the flag of the vessel. And as you are probably aware, there are very large numbers of so-called flags of convenience located primarily in countries that have, in fact, little or no tax. That is a separate matter.

What the proposal would do is to shift to a resident space reciprocal exemption so that when we say we are going to exempt income of the other countries, we know that, in fact, the people who are getting the benefit are the people who are resident in the other countries.

That raises the compliance issue.

Senator Symms. What if you have a Greek and an Italian and an American, say, or a Greek, Italian and Frenchman in a consortium and they own a ship? How do you treat that, then? And they fly a flag, say, from Liberia?

Mr. Shay. What the proposal would say is so long as 50 percent of those owners are from countries with whom we have reciproal exemptions. And I don't have the exact number. I would be happy to get it for you. We have reciprocal exemption arrangements with a great many countries on a resident basis under our tax treaties.

If 50 percent or more of the owners are resident in those countries, then not only would the gross tax not apply -- that wouldn't apply in the first place because of the narrowing I suggested -- but our income tax would not apply to that income.

The question you are raising is how would we identify and confirm the owners, particularly in a consortium arrangement. That is a subject that a number of the foreign shipping interests have raised to us. We think it is serious, and that we want to develop a system that is not going to impose a crimp on the international shipping. And we have asked them to provide us with comments to be sure that we, in designing the mechanism, do not have that result.

Senator Wallop. Can I ask for a clarification on that? When you say as long as 50 percent of those people are resident in those countries, which are those and which are those? I mean it is an open-ended concept.

Mr. Shay. So long as 50 percent of the owners of the shipping enterprise that is earning the income from shipping to or from the United States are resident in countries that have reciprocal exemptions from their tax on our shippers.

Senator Wallop. Not in the flag country, then?

Mr. Shay. Not in the flag country. In the country of residence.

Senator Wallop. Thank you.

The Chairman. Go ahead, Mary Frances.

Ms. Pearson. Mr. Chairman, we are now on Page 89, Number 6.

Senator Bentsen. I would like to ask a question.

The Chairman. Excuse me, Senator Bentsen.

Senator Bentsen. Let me understand this 80-20 rule. I understand that if 80 percent of the income comes from abroad then dividends paid out to U.S. shareholders are going to constitute a foreign source income so that they increase the foreign tax credit limitation.

Mr. Brockway, I would like for you to respond to this. However, the dividends paid to foreign shareholders would be treated as U.S. source, and, therefore, subject to the U.S. withholding tax. That seems to me a disparite treatment. Would you explain that to me, why that is justified?

Mr. Brockway. Well, Senator, I think the original proposal of the Treasury Department would have said simply that any 80-20 corporation which is a U.S. corporation, 80 percent of its income is from foreign sources, that we would treat that the same as any other U.S. corporation -- treat all the interest and dividends paid by that corporation as being U.S. source and imposing it to the withholding tax.

What they ended up doing on the House side on dividends is retaining the rule where there is a foreign parent corporation, treating that as U.S. source income so that where you have a situation of a foreign parent corporation setting up a U.S. intermediate holding company, then having operations overseas, saying that to the extent they decided to use a U.S. corporate shell, then there would be a requirement that those dividends be treated as a payment the same way as any other U.S. corporation and be subject to U.S. withholding tax under the treaty regime.

Oridinarily, it would be 30 percent but then it may be reduced to, let's say, five percent.

Senator Bentsen. But on the one hand --

Mr. Brockway. Essentially a place for using a U.S. corporation, I think.

Senator Bentsen. But on the one hand it is called foreign source income. And on the other hand, it is called U.S. source on the 80-20, depending in the foreign recipient and the domestic recipient.

Mr. Brockway. Where there is a domestic recipient, there is a look-through to see what the nature of the income is. And if that income were subject to foreign tax, then there would be a foreign tax credit allowed to the U.S. parent corporation.

Where you have a foreign recipient, I think it is a situation where the policy decision was simply to ensure that there was some cash generated if the foreign corporation decided to route its investments through a U.S. corporate shell on the dividend payment outside the U.S. It is simply a conclusion that was reached by the Administration and then by the House that if a foreign entity decides it wants to route investments through the United States and use a U.S. corporation, there should be some U.S. tax on that investment flow.

Senator Bentsen. It seems a bit in conflict. That is why I am --

Mr. Mentz. Well, the reason it seems a bit in conflict is it is a targeted provision designed to catch the one situation where a foreign company investing in the United States and sets up a U.S. company as a holding company; that U.S. company has other investments from non-U.S. --

Senator Bentsen. Has some foreign investments.

Mr. Mentz. Right. Has some foreign investments. Gets more than 80 percent of its income from foreign sources and thereby pulls a dividend up out of the U.S. That is tax free or taxed at seven percent because it is U.S. to U.S. And then it goes out back to the U.S. parent -- back to the parent of the U.S. holding company without any further tax because of the 80-20 rule.

It is just that limited case that this proposal is intended to hit. And that is the reason it is different between who the parent is, whether it is a U.S. or foreign parent.

Senator Bentsen. Thank you, Mr. Chairman.

Mr. Brockway. In the case of a U.S. payee, that income is going to be subject to tax in the hands of the payee, fully subject to tax, with the foreign tax credit allowed. To the extent that a dividend is paid to a foreign parent, there will be no U.S. tax at all by virtue of the arangement whatsoever.

The Chairman. Go ahead.

Ms. Pearson. Yes. Thank you.

We are on Page 89. We just covered Number 7. Number 6, we skipped over -- other offshore income and other income earned in space.

We sourced it in the place that the resident lives. For example, if there is a U.S. owned satellite, all income will be U.S. sourced.

We are now on Page 90 -- allocation of interest from other expenses. The Chairman's proposal adopts the President's and House's proposal based on two theories. First, we treat all U.S. corporations with foreign subsidiaries as one multinational corporation for purposes of averaging the foreign tax credits.

Therefore, to follow through on this, we treat them all as one corporation for purposes of allocating expenses.

Page 91, we are now in the treatment of U.S. taxation of income earned through foreign corporations. This is also known as Subpart F income.

Senator Wallop. Mr. Chairman, before we go on to that, is this the area which is causing some concern? That is, to where you have a wholly owned but wholly independent domestic subsidiary of a corporation doing multinational work otherwise? That you tax the -- I mean that you average interest payments of the wholly owned and wholly independent and wholly domestic operation?

The Chairman. It is, but what we have done is basically adopted the theory these corporations have talked about for a long time when they come here in terms of their requests as to how they want to be taxed. And they say they are an integrated operation, and that you should look at the whole corporation. And that is, indeed, what we have done here is look at the whole corporation.

Senator Wallop. I guess I am not certain as to exactly what you are saying, Mr. Chairman. It just strikes me that if you have a wholly owned, wholly independent operation, that is, entirely domestic and entirely within the confines of the economic spectrum of the United States --

The Chairman. A good example would be Mobil Oil and Montgomery Ward, which they own. Anybody who makes loans to Montgomery Ward, if they are at all rational, is looking at the value of Mobil in addition. And Mobil, over the years --

Senator Wallop. Mr. Chairman, you might say that, but I would doubt very much, I would seriously doubt, that under the corporate laws of the United States that Mobil would do that. That the obligation would be fundamentally, totally and 100 percent the obligation of Montgomery Ward. And that if Montgomery Ward were to go bankrupt, that it would be unaffected by the ability of Texaco to pick up their -- I mean of Mobil to pick up their obligations in a bankruptcy proceeding.

I doubt that anybody -- I doubt that they would permit a loan to tie the two corporations together.

The Chairman. Well, Malcolm, all I can tell you is that the companies, including the major oil companies especially, have come into this committee time after time saying they are worldwide operations and that their money is fungible. This is when they want to argue against the per country limitation or something like that, and they talk about being a worldwide operation.

I don't think you can have it -- I don't mean you, but I don't think they can have it both ways and argue that they are totally separate and unintegrated for some purposes and want to argue that they are totally integrated worldwide for other purposes.

Senator Grassley.

Senator Grassley. Yes. Along this line, Mr. Chairman, let me ask the Chairman what he would feel about an exemption for companies up to a certain size. And relatively small companies I am talking about.

What you are after here is revenue. And if that didn't have a revenue impact, how you would feel at a certain threshold.

The Chairman. My mind would be open. I hadn't thought about it.

Senator Grassley. All right. Well then let us just leave it that way for now.

The Chairman. All right.

Senator Grassley. I will visit with you about it.

Senator Chafee. Mr. Chairman, I wonder if Ms. Pearson could just pause for a breath at the end of each page. She plunges to the next page before I'm fully in gear.

The Chairman. I thought she was doing quite well.

Senator Chafee. Well, if speed is the requirement, she is doing extremely well. If cognizance by the Committee of what we are having here, I would say she is doing less well.

The Chairman. Well, hopefully --

Senator Chafee. I know this is a big section and goes on and on, and I am not asking for a 40 second pause. I think perhaps --

Senator Long. I want to ask one point. Have we agreed to this area where we are talking about how you allocate the interest expense. Like if Montgomery Ward and Mobil were mentioned. Like if Montgomery Ward borrowed some money. Are we now in that area where we are talking about -- do you allocate that to the overseas operation of Mobil?

The Chairman. We are discussing it right now.

Senator Long. Well, I am glad we are discussing it because I don't know this much about it, but I have heard enough to where I want to be educated a little bit on this.

Now if you assume that Montgomery Ward is entirely a domestic operation doing business here in the United States, is there any basis to tax Mobil Oil any different than you would tax them if it was just a corporation operating here and abroad, without owning Montgomery Ward?

Mr. Mentz. Maybe I might try my hand at that answer, Senator Long.

The question that we are dealing with is -- I am trying to give you a picture of what we are up against because this is a tough area, and I think it is important to have some understanding of it.

The issue is, again, computing the numerator of the foreign tax credit limitations going to affect how much foreign tax credit internationally based companies are going to be able to take against their U.S. tax liability. And the question is: How much interest is allocated to that foreign income and therefore reduces the numerator?

And the more that you allocate, the lower the fraction, and, therefore, the lower the credit.

Now what we have under current law is a set of regulations. The Treasury promulgated these regs back in the mid-70's. And they basically say each company separately makes an allocation so that Montgomery Ward is a U.S. company. It figures out whether it has got U.S. or foreign assets, and it allocates interest, allocates and apportions interest, in accordance with its own assets.

Now its own assets are all domestic. So all of its, under current law, interest is domestic. And what has happened under our regulations is the tax planners for the major corporations -- and certainly, again, nothing wrong with this -- structures have been created where you have a parent corporation and underneath the parent you have subsidiaries that are domestic.

And even if they have foreign income, if their foreign income is not greater than 80 percent, they are counted 100 percent domestic under our regulations.

So you set it up with the parent company doing all the borrowing. The first layer of subsidiaries is domestic. So all the interest expense is allocated 100 percent domestic, even though the borrowing may have been made to finance an acquisition, and the acquisition may involve substantial foreign assets.

It is obvious that that is producing the wrong result. So the President's proposal, the House and the Chairman's proposal all are designed to try to change that and make the result more rational.

The Chairman's approach does it by taking the fungibility theory and extending it to basically his proposal. And what he is really saying is, look, it doesn't really matter whether the borrowing is in Montgomery Ward or whether it is in Mobil or whether it is in any other U.S. affilitate. Money is fungible and wherever the borrowing occurs, you can assume that that U.S. company is going to arrange -- can arrange its borrowings to produce the intended tax result, if you let it.

So by combining the whole thing, which the Chairman's proposal does, and which the President's proposal would do, it wouldn't matter whether the borrowing was in Montgomery Ward or whether it was in Mobil or whether it was in some other subsidiary. You would look at the total foreign assets of the group and allocate and apportion the interest on that basis.

And to come back squarely to your question, you asked does that treat Mobil subsidiary, Montgomery Ward, differently than if Montgomery Ward were operating separately and independent of an international company. The answer is yes.

And the reason it is stated differently -- I think the Chairman expressed it -- is that an internationally oriented company that has foreign operations looks at its business as one integrated business. And they come in and they argue that when they argued against the per country limitation.

What we are basically saying is, fine, if that is the position, we will accept it; we get rid of the per country limitation. But we will put all the interest together. And, indeed, your proposal softens the President's proposal because you take account of foreign borrowing and foreign subsidiaries.

That is a long-winded answer, and hopefully some explanation of this subject matter.

Senator Long. But it seems to me that when you talk about the per country limitation, the overall limitation or the per country limitation, in any event you still have got us against them. In other words, if you are doing business in the United States, the result comes out one way. If you are doing business overseas, it comes out another way.

And if you are talking about a country that -- there is a company that has, let us say, a domestic subsidiary operating entirely here. It doesn't make much sense to me to think that you are going to have a much different tax result because they had an operation overseas.

In other words, let us take the situation that existed when the -- before Mobil acquired the Montgomery Ward. I don't understand why there should be much difference in the way the thing works out or any substantial difference because Mobil acquired Montgomery Ward from what it was before they acquired, assuming Montgomery Ward is entirely a domestic operation.

Is that how it was?

Mr. Mentz. I believe that is right. Your point is a troublesome one. My only answer to it is if you allow the subsidiary that borrows on its own credit and has only domestic operations to allocate its interest solely domestic, as Montgomery Ward -- as I take it you would expect and think that Montgomery Ward should -- frankly, we have considered this as an alternative. And it does have some appeal.

But the problem with it at least that I have, and haven't been able to resolve in my own mind, is how do you stop the company, the domestic subsidiary, that has some borrowing capacity and it borrows right up to its limit and then either distributes the excess cash to the parent or buys some U.S. assets of the parent, leases them back, or buys some receivable or somehow finds a way, a legitimate non-evasion but nevertheless legitimate creative way of moving that money out of the domestic sub up to the parent and then the parent uses it in its foreign business -- it just seems to me that you get into a kind of a tracing theory if you go down that road that has a great deal of complexity and difficulty associated with it.

And I guess if someone could show me how to avoid that, I might be more sympathetic.

Senator Long. Well, in years gone by before we had the TV cameras in the room and before we had the openness rule and all the rest of it, we used to get in this room or even in a smaller room, the conference room behind, and take a blackboard. And somebody would put it up there on the blackboard and explain from the point of view of the Joint Tax Committee, let's say, or the point of the Treasury.

And then somebody would put the other side of the argument up on the blackboard. My impression is you can draw a picture of the thing and one takes it one way and the other then takes it the other way and show what the tax difference is. For most of us, the answer was simple, which was wrong. If you could get them both on a simple chart, a diagram, where you can see which makes a better sense --

Mr. Mentz. Well, we will do a couple of pictures for you, Senator.

Senator Long. Now while you are doing it, I would like for you to let the other guy have one too so that you can see it the two ways and then see which one makes the better sense, almost as if we were a judge or judges trying to judge the case. See which side makes better sense.

Mr. Mentz. Well, that is fine. And let me say I am very much in agreement that we ought to be adopting the rule that makes the most sense. I am not trying to say it ought to be this way, by God, no matter what. And if we can help get to the merits that way, that is very much what I would like to try to do.

Senator Long. If the companies are getting away with some michief here, I want to stop it. But on the other hand, if they are being treated unfairly, I don't want to do that either. I want to try to do what is right.

Mr. Mentz. My concern is that if you go in that direction, just like you have the companies arrange -- have their financing arranged as I described it earlier, with the parent borrowing and then a layer of domestic subs, I think what you would have would be you would have as much borrowing as possible pushed down into the subsidiaries that don't have any foreign activities. And that would be the optimum way of effectively managing your financing for tax purposes.

Some companies can do that, some can't. My guess is that Montgomery Ward is probably pretty well borrowed up and wouldn't have a lot of extra credit capacity that they could borrow and route around to the foreign operations of Mobil.

So it may differ company to company. Anyway, I will get you some pictures.

Mr. Wilkins. Mr. Secretary, I would like the minority staff to be able to participate in the preparation of some of those illustrations.

Mr. Mentz. Sure.

Senator Long. What?

Mr. Wilkins. I would just like to say that our staff would like to help participate in drawing those pictures.

Senator Long. I would like for you to do that because --

Mr. Mentz. You draw better than I do, Bill, anyway.

Senator Long. I just want to see both sides of it in some fashion that we can understand both sides. It just seems to me in my simple mind that if here is Montgomery Ward, a domestic company, here is Mobil, an international oil company -- and so the two of them merge. One acquires the other. To my simply thinking, they ought to owe the same amount of tax they owed before they merged.

But I would like to see it put together in a way where we can see what the difference would be and why. It may be that you are 100 percent right. I would just like to see it in some fashion that I think I understand it, and I think I know who is right. That is all I want. And I think most of us feel that way.

Mr. Mentz. Good.

The Chairman. Go ahead, Mary Frances.

Ms. Pearson. All right. We are on Page 91 -- U.S. taxation of income earned through foreign corporations.

Senator Heinz. Mr. Chairman, before we leave this section may I just bring up one other issue, a different issue?

The Chairman. Yes.

Senator Heinz. Has anybody discussed, as yet, what is called the AT&T problem?

Ms. Pearson. No, Senator Heinz. That is back on Page 89. And it is other offshore income and income earned in space, Number 6.

Senator Heinz. Mr. Chairman, would you prefer that I withhold the discussion of this until --

The Chairman. This is where we allocate the space income to domestic corporations?

Ms. Pearson. Yes.

Senator Heinz. Yes.

Ms. Pearson. If it is earned by a U.S. company.

The Chairman. Pardon me. If it is earned by a U.S. company.

Senator Grassley. Senator Heinz, you are asking about the transoceanic cable, too?

Senator Heinz. Yes. That has not been discussed? Do you want to discuss it now or later?

The Chairman. We went by the space income.

Ms. Pearson. Yes, we did.

The Chairman. Why don't we go ahead and do it now?

Senator Heinz. All right.

I am advised, and maybe staff can fill us in, that we are making a change from current law here on the way the receipts from toll calls coming into the United States and toll calls going out of the United States are handled. Who is best prepared to discuss that?

Ms. Pearson. Well, Senator Heinz, AT&T came into us after the spread sheets had gone out. We would like to look at this a little further. And the problem with American Telegraph and Telephone is that they don't know how their income is sourced. Whether it is 50 percent U.S. or 50 percent foreign. They would like it clarified. It is not even clear under current law.

Senator Heinz. And so you are aware of the problem and you are working on it?

Ms. Pearson. Yes, sir.

Senator Heinz. All right.

Mr. Chairman, I am glad the staff is looking at it. I am not sure I know what the right answer is myself. As I understand the spread sheet that we have before the Committee, what it would do is presume that, if I understand it correctly, that all income from international communications handled by AT&T would be considered U.S. sourced income. And you don't have to be too much of a conceptual thinker to realize there are calls coming in, there are calls going out. Some are handled by satellites up in space that are outside of our borders. Notionally, I don't know exactly where to place them, but, clearly, it seems judgmentally that considering all incomes from all calls, whether they are originating here or originating abroad, U.S. sourced income is probably wrong, although I don't know what is right.

Ms. Pearson. I would like David Brockway to make a comment on that point.

Mr. Brockwy. I think, Senator Heinz, the rationale on this treatment of this income that is not resources within any country -- income, let's say, from the space satellites -- treating it as U.S. sourced is that the general theory of the credit is that you would want to relieve double taxation.

If you have income that is likely to be

subject to foreign tax, is subject to foreign tax, then we will basically say the foreign jurisdiction has first priority to tax that income; we should allow a credit. Moreover, you have overall so you can average income from various foreign countries.

In a regime, situation, such as this, the income is not likely to be subject to foreign tax. A U.S. resident out doing business in the United States, and the income, essentially, probably won't be falling in any -- it is not clear where physically the income is coming from but it is fairly clear the income is not going to be subject to foreign tax.

If it isn't subject to foreign tax, then the theory here is that an excess credit from unrelated activities or other activities should not shelter this income because this income itself is not being subject to tax. That's why it is being sourced to U.S. That is the theory of the proposal on the spread sheet.

Senator Heinz. And that may be a perfectly reasonable theory as long as nobody else is taxing that income. And I just don't have enough information on that.

Mr. Brockway. That is what we are exploring with the phone companies on this.

Senator Heinz. Very well.

Mr. Mentz. Senator Heinz, there is another aspect to this. It may not be relevant to AT&T, but for a start-up operation where there may be losses, this rule sources the losses U.S., which means it does not reduce the foreign tax credit limitation.

So it is kind of a -- in one case it helps the taxpayer and in another case it hurts.

Mr. Brockway. Yes. I should say it originally came in because of some concerns on certain satellite income where generally under our depreciation rules you are likely to have losses on the lease of a satellite. And they said they preferred to have it be U.S. source income rather than foreign source so it wouldn't adversely affect their foreign tax credit.

Senator Heinz. Thank you very much, Dave, Mr. Mentz.

Mr. Chairman, did Senator Baucus bring up his possible amendment on the allocation of interest and other expenses? Did you bring that up, Max?

Senator Baucus. No, I didn't. I understand that the subject was raised earlier today, and I agree with the comments from Senator Long and others who spoke on it. I plan to raise it at the appropriate time. I generally agree with the discussion.

The Chairman. The issue has been raised rather extensively.

Senator Heinz. I just want to point out -- and if I am redundant, I apologize to my colleagues -- that depending on what is going to be offered, it may or may not solve the problems of some financial institutions, such as insurance companies. I am advised that the SIGNA group, for example, has a very unusual situation where they have a considerable amount of actual income abroad that would be treated in an extraordinary fashion here.

And can the staff tell us what they understand is pending in the way of a modification?

(CONTINUED ON NEXT PAGE)

Ms. Groves. Senator Heinz, I think one of the problems with the insurance companies, I am not sure that it necessarily has to do with the allocation rule that is in place as to additions to reserve, such as the addition that you make to a life insurance reserve over the life of the policy.

That is sometimes referred to as interest, and it might fall subject to the interest allocation rule, and whether perhaps the proper rule might not be to treat those as additions to reserve as not being the type of interest--not calling them interest for purposes of interest allocation.

It is my understanding that that might be what they are talking about, rather than the actual allocation of interest formula.

Senator Heinz. There are really two kinds of interest expense that are involved here. One is interest earned on corporate debt, and I don't think there is any argument as to how that ought to be treated, which is the way it is treated in the chairman's draft.

The other issue is the investment of assets for interest that is credited to policyholders, and that is the one that is at issue here.

Ms. Groves. Yes. I think that there are going to be two types of expenses. One is the reserve addition, which sometimes are referred to as interest; and I think that is one of their major concerns.

Senator Heinz. Yes.

Ms. Groves. That that reference doesn't make them interest for purposes of this rule. And there are some other things that are --

Senator Heinz. That is exactly the concern. Are you saying that it was not the intent of the staff draft to do that? Or is the intent of the staff draft now not to do that?

Mr. Wilkins. I am not sure that there have been extensive discussions on it. It may be something that needs a little work.

Ms. Pearson. Senator Heinz, we will discuss it further and get back to you on that point.

Senator Heinz. Yes. All right. Thank you very much. I did hear that.

Lastly, I understand that there is a problem with the subpart (f) fules and the way they work with the trust rules, and the staff has been working on that. Is that right? And you are getting close to a resolution of that?

Ms. Pearson. That is right, Senator Heinz.

Senator Heinz. All right. Thank you very much. Mr. Chairman, I want to thank you.

Senator Symms. Mr. Chairman, I am sorry and I apologize if this has been brought up extensively; maybe it doesn't need to be, but I got in as Senator Long was discussing the question of a company that has domestic operation and foreign operation, but in that process of what Senator Long asked for, is the question of a company that has had to fight off a hostile take-over and has incurred a big debt? Has a transition rule been talked about to explain how that will impact them?

The Chairman. No, we haven't.

Senator Symms. I am talking about the UniCal case specifically, but have you looked at that? I am told that they need a transition rule.

The Chairman. Is that in this section?

Senator Symms. It is in interest allocation.

Ms. Pearson. We have a generic transitional rule, and we were going to take up transitional rules at the end and discuss it then. However, if --

Senator Symms. All right. Excuse me. If this isn't the proper place, you can do it when you want to; but I wish you would address that for me when you get to it.

Ms. Pearson. Certainly, Senator.

Senator Symms. Or do it now if it is all right with the chairman.

The Chairman. No, I would rather save all the specific transitional rules until the end.

Senator Symms. All right. Now, do you mean at the end of the entire mark-up?

The Chairman. That is right.

Senator Symms. Oh, all right. Just keep that one written down.

Mr. Brockway. Mr. Chairman, if I understand this proposal, if it is the Unical one, it is not exactly a transitional rule. I think what they need is a liberalization from present law; that is what their problem is. It is in this allocation of interest expense rule, but under present law, they do not get the preferred result and they need a change, given the way they structured their investment.

The Chairman. You mean they don't like either present law or the draft?

Mr. Brockway. My understanding is that the present law is where they have a problem, from where they borrowed within the group.

The Chairman. All right.

Ms. Pearson. Mr. Chairman, we are now on page 91 again for U.S. taxation of income earned through farm corporations.

The Administration did not have a proposal in this section, and we generally keep present law. We add a few types of passive income to subpart (f).

The rest of page 92 is really more a House description of how they changed and tightened subpart (f) to include certain items of active income.

We again keep with the original theory of subpart (f) that it would apply to passive income and when it is between related parties because those tended to be ones that were abusive for the penalty tax under subpart (f).

Moving along to page 94, it is a discussion of the special tax provisions for Puerto Rico, called The Possessions Tax Credit.

We keep the current law, Possessions Tax Credit; however, we adopt some of the House bill which tightens the method of allocating intangible income.

We also adopt the House bill that provides a qualified possessions investment income be made by the government development bank.

On page 95, it is a discussion of the wage credit proposed by --

Mr. Mentz. Mr. Chairman?

The Chairman. Mr. Secretary?

Mr. Mentz. Could I just interrupt there for a minute?

We have been in discussions with the representatives of the Government of Puerto Rico in connection with an expansion of the so-called QPSII rule,Qualified Possession Source Investment Income.

The House bill basically provides only that funds routed through the government development bank would be available for investment in Caribbean Basin countries.

This was part of the initiative of working the subject out with Puerto Rico. It was to effectively have this twin plant concept to harness the activities and financial resources of 936 companies in Puerto Rico to effectively inject funds and financial assets into other areas of the Caribbean.

The House bill provides that funds must go through the government development bank. Our discussions have led to a suggested modification that would permit funds to be routed through commercial banks in Puerto Rico--936 funds--that as long as the investments are monitored and approved by the Secretary of the Treasury of Puerto Rico, the effect would be that the loans made by the 936 companies would still have interest that would qualify for this favorable tax treatment.

It would make it easier for the Government of Puerto Rico to make its commitment of $100 million a year investment in the CBI.

So, subject to working out the technical statutory language, I just want to express the Treasury's support for that concept.

The Chairman. I am delighted. Thank you.

Senator Long. My understanding is that the Government of Puerto Rico is asking for two changes. The other one was to expand the definition of qualified investment of CBI countries to include infrastructure as well as direct business investments.

Mr. Mentz. That is right. I omitted that, but we are on board with that one, too, Senator.

Senator Long. I don't understand it too much, but if you people think that it ought to be that way, I am certainly willing to go along with it.

Mr. Mentz. The idea is to try to get some of these funds available not just for financing a plant, but for building a road, in a country that is in the Caribbean Basin where we have certainly a national interest, but to date, have not really had any financing.

Senator Moynihan. Mr. Chairman?

The Chairman. Senator Moynihan?

Senator Moynihan. Could I just make a general observation that we certainly seem to wander a long way from the concept of tax reform as it appeared in Treasury I, which was as much as possible to produce a sort of policy-neutral tax code, which principal purpose is raising revenue.

And I suppose it is part of the general atmosphere of a government which is having a decade-long crisis of fiscal policy, and just living with the deficit constantly, that we find ourselves in the process that begins with the objective of having as few policy judgments in the Tax Code as possible, the idea being to let those policy judgments be made in positive law through the budget.

We find ourselves here devising a tax code that is, among other things, designed to carry out an initiative the Secretary of the Treasury made seven weeks ago and may change in nine weeks' time, and which among other things defines Argentina as a less developed country. You know, Argentina is not an LDC by any conceivable standards; but that is one of the 15 standards of the Baker initiative.

We are writing the Baker initiative into the Tax Code. Now, we are writing the Caribbean Basin initiative into the Tax Code.

In ordinary circumstances, that kind of thing would be done through foreign aid legislation.

The Chairman. Let me defend what the Treasury wants to do, though, and we do this all the time and I think justifiably.

It is one thing to tilt toward neutrality where we say we don't care what happens in the marketplace. We are just going to have people invest in terms of an economic basis. If they want to invest in a grocery store or a duplex, they ought to do it because they are a good grocer or a good property manager.

But where we have decided to do something beyond the marketplace--and the Caribbean Basin initiative clearly is--because what we want to achieve would not be done if we just threw our hands up and said, oh well, no tax incentive or no appropriations.

Then, I think we are better off to go the tax incentive route than the appropriation route. Either is a legitimate use of the law to induce a government policy, and I think the tax --

Senator Moynihan. If you have a particular view of the Tax Code that says that, then you and I do. But I mean, the policy impulse behind tax reform is of the other --

The Chairman. And you and I fortunately don't share that view.

Senator Moynihan. Yes.

The Chairman. Yet, the true tax reformers would have the Tax Code used to induce no social purpose. If you want to have health insurance, don't have employers provide it without taxing the benefits of the employees; have national health insurance and tax everybody, collect the money, and have a Government administrative branch of some kind to run it.

Don't encourage people to own homes by a mortgage interest deduction. Have a national housing corporation. If you want to buy a house, you go down and fill out a grant form. Several weeks later or several months later, the form will come back, hopefully.

It will probably be requesting more information, in all likelihood; and by the time you want to buy the house, the house is gone, anyway, to somebody else.

But I would much prefer, when we finally come to the decision that we are going to do something beyond the market, that we could use the Tax Code for it rather than appropriations.

Senator Bradley. Mr. Chairman?

Senator Chafee. Mr. Chairman, I just want to put a caviat on to what you were saying. All activity would not grind to a halt in this nation if there was not an incentive in the Code; and the suggestion that no one would buy a house if the mortgage interest wasn't deductible, I think, is carrying it a bit far.

The Chairman. I didn't say no one would buy a house. Maybe 10 percent fewer people would buy a house, but for years, we have thought it was a wise policy to encourage home ownership. And we have had a variety of devices, including appropriations, to carry that out.

And all I am saying is that, if you are going to encourage something beyond what the market would otherwise do--I am not saying all activity would cease--then you have two choices: appropriations or tax incentives.

And once that you have made the assumption that you want to encourage something beyond the marketplace, I think the tax incentive is a better route to go.

Senator Chafee. Well, we know your view on that, and it has been forcefully and vigorously and ably set forth on many occasions.

The Chairman. Senator Bradley?

Senator Bradley. Mr. Chairman, if I could, I would just like to follow up on what Senator Chafee said.

You neglect to mention the result of using the Tax Code to promote a variety of activities. The result is middle income people and low income people end up paying higher tax rates.

And one way to describe tax reform is to say that one who wants tax reform does not believe the Code should be used to promote any other activity.

Another way is to say that one who supports tax reform believes that lower tax rates are of value to middle income people and to low income people and that the market is the most efficient allocator of resources.

I mean, that is a theme that you continue to come back to. I know that that is not what we are dealing with, and I know that that is not the way the Code has developed over the last 30 or 40 years.

But that is the question that tax reform poses, and I think to say or to portray that for average taxpayers out there, there is only a lose-lose--meaning you will lose your benefit and you end up with a giant Government bureaucracy--is just not correct.

You end up with a lower tax rate. In many cases, that means more money in your pocket, and there is no reason to believe that the result is going to be that you lose access to, in the case that you posed, health care.

I just don't think that that is going to happen. People are going to continue to need health insurance. They are going to continue to look for group health insurance, and they are going to have more money in their pocket to pay for the group health insurance, if that was the extreme case that is being posed, which is not being posed in this bill.

What we are talking about in this bill now are a variety of benefits that go to very narrow sectors of our economy. We are not talking about benefits that flow through to the majority of the population, as lower rates do.

The Chairman. Senator Long?

Senator Long. Mr. Chairman, now we will go through this in this debate--I will retire from the Senate at the end of this year. I won't live long enough to see it, but if I were here 50 years from now, we will still be debating whether it is better to encourage something by way of a tax advantage or whether it is better to do it by way of a direct appropriation or whatever.

(Laughter)

Senator Long. Now, I always think of it somewhat like when you sit down to eat a meal. You have a knife, you have a fork, you have a spoon; and you use whichever one serves the purpose better.

(Laughter)

Senator Long. So, if you compare an appropriation bill to a fork and you compare a type of subsidy, if you are eating soup, you ought to use a spoon.

(Laughter)

Senator Long. But there come certain things when no one of the three works very well. If you are trying to eat escargot--French snails--none of them do it right.

(Laughter)

Senator Long. The fool thing is in a shell, and you can't even get it out of there without holding that greasy, garlic thing in your hand and sticking a knife in there.

(Laughter)

Senator Long. So, you figure out something else to do it with. Now, Treasury has talked about getting rid of section 936; and so, they went for that for a while.

And the Governor of Puerto Rico opposed that. They don't have any Senators here to represent them, but they worked hard at it to get their point across.

And I think they persuaded the majority of us on both sides of the aisle, the majority of both parties, and I think they persuaded the Administration that 936 stays.

All right. So, if 936 is going to stay there, they said here are a couple of minor things that are wrong about it. For example, when 936 was passed, we didn't have the CBI, the Caribbean Basin Initiative.

Now, since we do have it, we would appreciate it if you would amend this thing and take the CBI into account.

That is what you are talking about, isn't it, Mr. Mentz?

Mr. Mentz. That is exactly right, Senator.

Senator Long. And so, if 936 is going to stay there, we ought to recognize that the CBI is now the law and try to make one geared with the other.

That is all that is involved here as I understand it.

The Chairman. That is as rational a presentation as I have heard of a very complex subject.

Further comments?

(No response)

The Chairman. All right. Mary Frances, onward.

Ms. Pearson. We are now on page 96.

Senator Long. Can we agree to go along with the Treasury recommendation on this matter?

The Chairman. I think so. I would like one more chance to look it over. Senator Bradley?

Senator Bradley. Mr. Chairman, does Treasury have a recommendation on the Virgin Islands as well as Puerto Rico?

Mr. Mentz. No, that recommendation is just for Puerto Rico, Senator Bradley.

Senator Bradley. All right. At some point, we might want to revisit the question on the Virgin Islands.

Senator Long. The problem never came up with the Virgin Islands, did it, Mr. Mentz?

Mr. Mentz. No.

Senator Long. And I don't know what the answer is. If someone wants to propose it, I will be glad to consider it.

Senator Moynihan. Can we get the Treasury proposal on the Puerto Rico matter in writing?

Mr. Mentz. Sure.

Senator Long. Here it is right here if you want to see it.

Ms. Pearson. Okay. We are now on the other U.S. possessions, beside Puerto Rico. U.S. Virgin Islands, Guam, Northern Marianna Islands, and Samoa.

On these we adopt the President's proposal, and this is a proposal which has been negotiated over a period of years to delink.

And I would like Steve Shay of Treasury to describe exactly the proposal.

Mr. Shay. Mr. Chairman, the proposal with respect to the Virgin Islands is to continue the mirror code with certain modifications that had been discussed over a long period of time with Treasury and the Virgin Islands.

And the chairman's proposal with respect to Virgin Islands taxation of Virgin Islands source income of foreign persons follows the House recommendation to allow the Virgin Islands to reduce its tax on that income if it feels appropriate to do so.

The proposal with respect to the other possessions, Guam, the Northern Mariannas, and American Samoa, is in essence to permit them to adopt a tax system governing their local source income as they may see fit, subject to certain limitations to prevent abuse of U.S. tax interests.

I think the next item, Mary Frances, is Item 3 on page 98.

Senator Bradley. If I could ask a question on the Virgin Islands? Are they allowed to rebate or reduce their tax on all non-U.S. source income earned by Virgin Islands corporations?

Mr. Shay. Under the proposal, that would not be the case with respect to non-Virgin Islands source income.

Senator Bradley. And what is the rationale on that?

Mr. Shay. The rationale is that the United States imposes its tax on worldwide income of the taxpayers. In deciding to follow the mirror code and thereby adopt the locked step except for their local source income, the Code has been placed in the United States.

They would also be cause to tax Virgin Islands income of Virgin Islands residents. I understand that the Virgin Islands is concerned about--or has some suggestion to not tax that income.

The concern that that raises for us is that, by adopting the Code, there come into play fairly complex interactions, and we would be concerned about them being used as a jurisdiction by foreign persons to essentially route income through that jurisdiction in much the same way as a number of tax havens do that are wholly foreign countries.

That is a concern that the Treasury Department has.

Senator Bradley. Is Guam treated differently than the Virgin Islands?

Mr. Shay. Yes. Under the proposal, Guam would be given authority to come up with its own tax system with respect to Guam residents. That is for both domestic and foreign income.

Until such time as they do, they would continue to follow the Code.

Senator Bradley. But if they came up with their new system, they could essentially reduce Guam taxes on all non-U.S. source income?

Mr. Shay. That is correct. As long as it is not U.S. source income and subject to an implementing agreement to be sure that there is again no abuse of U.S. tax interests.

Senator Bradley. So, the difference is that Guam opted to do its own tax code, and the Virgin Islands opted to stick with essentially the U.S.? Is that the difference?

Mr. Shay. That is the principal difference between the two. Yes.

Senator Bradley. What is the rationale for penalizing the Virgin Islands in this case for staying with the present

Code as opposed to developing its own?

Mr. Shay. In our view, Senator, that shouldn't be a penalty. We presume that when Guam exercises its authority with respect to taxing foreign income, it is going to do so in a way that is not oriented towards a conduit type investment.

Assuming that that is correct, I don't see that there is a substantial difference between the two situations.

The Chairman. Let me ask, Bill. Unless I am mistaken, the Virgin Islands has not asked for that privilege, have they?

Mr. Shay. Initially?

The Chairman. Yes.

Mr. Shay. No, they did not.

The Chairman. Have they recently?

Mr. Shay. My understanding is that they have made a proposal that they would like to be able to reduce their tax on foreign income of Virgin Islands that would not otherwise be indirectly taxed by the U.S.

The Chairman. Yes. The reason I asked, Bill, is that, unless they have changed, they didn't want to get into the hassle locally of having to debate this issue.

And to the extent that they mirrored us, there is no problem. And my hunch is that if there were to ask, they could have it; but all that does is, they think--or thought--

cause them great problems in their legislature, that they chose for whatever reasons not to get into.

So, it was easier to say the law just mirrors the Federal Code.

Senator Bradley. We might want, when we come back to this, to discuss this further.

The Chairman. I would be open to change, but that was their position. That is why I asked if they had changed recently. That was their position some time ago.

Senator Moynihan. Can I say that Mr. Lugo has asked--he called on me and maybe others--and they may have something --

Ms. Pearson. Mr. Chairman, we are now on page 98, number three.

This is taxation of U.S. employees of the Panama Canal Commission. There is some dispute whether the Panama Canal Treaty exempts U.S. employees from both the U.S. and the Panamanian tax.

The United States Treasury holds that it just exempts them from Panamanian tax.

We adopt the House bill that clarifies that the Panama Canal Treaty exempts U.S. taxpayers from U.S.--excuse me, U.S. taxpayers from Panamanian tax, not U.S. tax; but we make it prospective.

The House bill makes it applicable to all open years.

On page 99, --

Senator Chafee. It seems to me that we spent a lot of time on that Panamanian treaty--on that Panama Canal Treaty.

You mean to say this wasn't clear?

I must say that I can't remember exactly. I thought we continued the existing system, as we went through that debate; but I could well be wrong. But it must be clear, isn't it?

Ms. Pearson. It is before the Supreme Court right now. Treasury and some other people thought that it was clear, that it exempted Panamanian tax only and not U.S. tax.

Senator Chafee. So, what this does is make it prospective? The House bill covers all open years.

Ms. Pearson. And what we want to do is allow the Supreme Court to make the decision for past years, and we will for the future say that it applies only to Panamanian tax.

Senator Chafee. Thank you.

Ms. Pearson. Okay. Page 99. These are all House bill proposals. We keep present law.

The Chairman. Senator Baucus?

Senator Baucus. Mr. Chairman, on page 99, item number 5, I had planned at the appropriate time to offer an amendment which would repeal Section 911, treatment of supplies for Americans living overseas in countries that are banned from American residency, in Libya for example.

The Chairman. Thank you.

Ms. Pearson. On page --

Senator Chafee. For a country that is what? Banned?

Senator Baucus. When an Executive Order issues an order that U.S. citizens are not to live in that country--Cuba is one of the countries, for example--it is my opinion that the Section 911, $80,000 exclusion should not be available.

The Chairman. Excuse me. I didn't hear that.

Senator Baucus. There are various countries on that list. I will pass the list down. I have it right here in front of me.

The Chairman. Thank you.

Senator Baucus. Right now, Section 911 applies to any American working in any foreign country. Currently, there are six countries that are subject to such a ban: North Korea, Cuba, Cambodia, Vietnam, Iran, and since February 1 of this year, Libya.

Presently, there are about 100 Americans still who have returned to Libya, and it is my feeling that they should not be entitled to an $80,000 exclusion that is presently available under Section 911 to Americans ordinarily working and earning income overseas.

The Chairman. And you will offer that when we get to the section?

Senator Baucus. That is correct.

The Chairman. Will that do, John?

Senator Chafee. Yes, thank you.

Ms. Pearson. On page 100, the chairman's proposal adds a compliance provision with respect to U.S. residents abroad.

We require that passport applicants complete an IRS information return disclosing where they are going to be.

Number 8, foreign investment companies. Under current law, foreign investment companies are not currently subject to tax on their passive investment income.

We impose an interest charge on the deferral of that income until they bring it home, or we allow an election for U.S. taxpayers to bring it home currently.

Senator Boren. Mr. Chairman, it is very possible that I will offer an amendment to that section. I am somewhat concerned about it.

The President's proposal and the Treasury proposal did not include action in the area of foreign investment to companies.

I think we have to be very careful that we not have a negative impact particularly on the ability of our service industries to compete in the international marketplace. And I am concerned that this provision might have some--and the House provision especially--negative impact, and even our draft provision.

I can understand the rationale for applying this rule where you have a majority control by American investors in a joint venture. There you could say that American investors have control over policy of distribution of dividends for example, but where American investors hold less than 50 percent, I think we should give some consideration as to whether or not those rules should apply since American investors would not have the ability, for example, to dictate policies as to such matters as dividends and when income might be realized.

So, I would like to serve notice that I might be offering an amendment in that area related to that point.

I might also mention--and there is no real place that this fits in with our draft document--but Senator Zorinsky from Nebraska had asked me to also raise a problem which a business operation in his State is having in regard to the expropriation of property by foreign governments.

Now, Senator Zorinsky has dealt with this matter in S. 2228, and it deals with the nationalization by Peru of a very large business operation headquartered with its principal home headquarters in the State of Nebraska; and I have agreed with Senator Zorinsky that I would raise this question at the proper time when we come back to the area of foreign taxation.

So, I do want to put staff on notice that I will, on behalf of Senator Zorinsky, be offering something along the lines of S. 2228, and also I won't revisit the area of interest allocation now--since others have spoken of that--but

I will also have something on that when it comes down.

But this section on page 100, I will likely have an amendment to those, where American investors have less than 50 percent of the foreign investment.

The Chairman. It is my hope we can mark up on Wednesday afternoon the foreign tax provision section. You should have a tentative mark-up schedule that has been distributed and in front of you for this week and generally the expected order--and there may be some variation--but the expected order of things for the next couple weeks after that.

Like this afternoon, I know there are one or two people that cannot be here, and there are some accounting issues they want to bring up. I am not going to slip those to you tomorrow. I will slip those to another section a week or two later.

I am going to try to stick to this schedule, and then catch up the miscellaneous amendments that we are unable to finish --

Senator Boren. Right. Later on in the week. Thank you.

Senator Chafee. Mr. Chairman?

Senator Moynihan. Mr. Chairman?

The Chairman. Senator Chafee? And then Senator Moynihan.

Senator Chafee. On Senator Boren's amendment--or his possible amendment--it seems to make some sense. What does Treasury say about that?

Mr. Mentz. I think that maybe the change here, Senator Chafee, is perhaps not worth it. I think we have support for Senator Boren's position.

The amount of revenue involved is pretty small. I think it is about $100 million over five years, and the idea of taxing a U.S. investor as a minority shareholder in a foreign business, where frequently you can't get the records, taxing them currently or having an interest charge as an alternative, I think may be a little too tough.

Senator Chafee. Thank you.

The Chairman. Senator Moynihan?

Senator Moynihan. Could I simply report, Mr. Chairman, that one of my associates is working with the committee staff with respect to this FIC question. I think we are going to work it out.

The Chairman. Good.

Ms. Pearson. We are now on page 101. This is the start of our taxing of foreign taxpayers.

The first one is the branch level tax, and it was proposed by the President. What this proposal does is treat foreign corporations and foreign branches operating in this country in a similar manner.

The second, retaining character of a --

Mr. Mentz. Before you leave that one, Mary Frances, I would note that that involves a treaty override in that provision, which is --

The Chairman. With everybody? Or just with one country?

Mr. Mentz. It is with any country to the extent that they allow treaty shopping.

The Chairman. Excuse me. Any countries that what?

Mr. Mentz. With any treaty shopping-- With any country that allows treaty shopping. There are, I think it would be fair to say, three or four countries that might be in that category.

We are presently in negotiations to try and take care of treaty shopping on a bilateral basis. I think that is the way to do it. And I think we are making progress in that respect.

But a legislative override, I think, is sometimes the wrong way to go.

The Chairman. Now, what if we gave you a stretch-out similar to what you asked on the other provision you want where we are going to override the treaty?

Mr. Mentz. As between an immediate override and a stretch-out, I will take the stretch-out.

(Laughter)

The Chairman. Go ahead, Mary Frances.

Ms. Pearson. Number 2, retaining character of effectively connected income. Foreign taxpayers will be subject to U.S. tax if they are effectively connected with a trade or business in this country.

Some foreign taxpayers will take depreciation and other ITC and then leave this country with their property, without recapturing those tax benefits.

We treat the removal of business assets from U.S. jurisdiction as a disposition for purposes of recapturing that income.

Number 3, tax free exchanges by expatriots. When U.S. taxpayers leave this country for the principal purposes of avoiding U.S. tax, we attach some of their income. We just broadened that.

Number 4, excise tax on --

Senator Chafee. Excuse me one minute. I would like to ask Treasury about Number 3, anyway, the tax-free exchanges by expatriots. What is your thought there?

Mr. Mentz. Well, Senator, this is extending a provision of the Internal Revenue Code, Section 877, dealing with an attempt to tax expatriots 10 years after they have renounced their U.S. citizenship.

I guess my practical answer to you is: I have found Section 877 to be almost never applicable. Most individuals, when they expatriate, figure out a way to beat 877.

So, I am not sure that this is going to do very much.

Senator Chafee. Are you for it or against it?

Mr. Mentz. I guess on the grounds that it is in the chairman's proposal, I am for it.

(Laughter)

Senator Chafee. Is that generally the rule that guides you in --

(Laughter)

The Chairman. I can assure you that is the rule only on things they don't feel overwhelmingly strongly about.

Mr. Mentz. Yes. I was going to say: I think you know me well enough, Senator Chafee, that that is not the rule that guides me generally.

Senator Chafee. What about two? The same?

Mr. Mentz. Two is a little tougher for us. We will frequently complain about other jurisdictions that try to impose a tax when U.S. businesses remove their assets.

The case where it comes up most frequently is drillers, where they are drilling in a foreign country and then they remove their rigs; and the foreign jurisdiction tries to impose a tax on the withdrawal.

We do everything we can to avoid that. I think we would be somewhat less able to do so with a consistency if this were to be enacted.

Senator Chafee. Thank you.

Senator Grassley. Mr. Chairman?

The Chairman. Senator Grassley?

Senator Grassley. I was out when you were on page 100. Could I bring up something on page 100, item number 8?

The Chairman. Yes.

Senator Grassley. And if it was brought up, then we don't have to go through it again. But under your proposal (2), whatever degree of U.S. ownership.

Why would we want "whatever degree of U.S. ownership" as opposed to a certain percentage of U.S. ownership? I don't have one in mind, but maybe 50 percent.

Was this discussed while I was out?

The Chairman. It was discussed, but that particular question wasn't. Mary Frances? Mr. Brockway?

Ms. Pearson. Yes, Senator Boren --

Senator Grassley. I would like to know the rationale of the justification for whatever the degree of U.S. ownership, as opposed to-- It seems to me we would want to imply a certain degree of U.S. ownership, a certain percentage of U.S. ownership, before it would be applicable.

Senator Boren. Senator Grassley, I raised that point a while ago.

Senator Grassley. Oh, you did?

Senator Boren. We are in exact agreement. I think that it might make sense to say that if American interests own more than 50 percent, there you have a degree of control. You have control of American investors, for example, as to what dividends would be paid.

I do intend to offer an amendment, and I would welcome your participation in it. I think at the very least we should not apply this rule if American investors own less than 50 percent of the foreign investment company.

Senator Grassley. Let me apologize for being out during that period of time.

The Chairman. Go ahead, Mary Frances.

Ms. Pearson. Okay. We are on page 102.

We did not adopt the House bill on excise tax on insurance premiums paid to foreign insurers.

Senator Baucus. Mr. Chairman?

The Chairman. Senator Baucus?

Senator Baucus. Mr. Chairman, at the appropriate time, I will offer an amendment on that provision addressing the issue that Secretary Mentz raised concerning the treaty overrides.

Apparently, under present law, pre-insurance excise tax is one percent, but because of the U.K. tax treaty, that did not apply to Lloyds of London and other major reinsurers under the British or the U.K. tax treaty.

It is my view that, frankly, we have to address that issue because it is a major loophole. I know that treaties are treaties, but loopholes are loopholes; and we have to find some way to address that.

The Chairman. Do you want to address yourself to that, Mr. Secretary?

Mr. Mentz. Yes. I don't think it is a major loophole. I don't think it is a loophole at all, Senator Baucus.

I think the way that the U.K. treaty works, which was a deliberately negotiated agreement, was that if reinsurance goes into a U.K. insurer, we do not look beyond that insurance to find out where it goes out or what happens to it.

And the reason the U.K. wanted this provision was that frequently insurance is bundled together, and you get a bunch of different kinds of risks--some U.S., some foreign--all together and then different slices may be reinsured out or may not be reinsured out.

And it is a very difficult administrative problem for a U.K. insurer to figure out how much, if any, of the reinsurance risk goes outside the U.K.

We tried to determine whether there was any so-called fronting, that is use by the U.K. treaty deliberately of its beneficial treaty provision in order to front for some insurer or reinsurer outside the U.K.

We could not determine that any such fronting was taking place. So, that in a nutshell is why we think the U.K. treaty provision makes sense.

Senator Baucus. Mr. Chairman, I might say that I don't see why the U.K. should be exempt. I think that, according to the Secretary's rationale, it should apply to all countries. I don't see why the U.K. has to be separate.

Second, the U.K. is now presently abrogating the treaty, or at least beginning to. They have just passed a statute in their House of Commons which would basically deny favorable tax treatment to U.S. corporations doing business in Britain, which are companies that operate in the U.S. in unitary tax states.

That clearly violates the tax treaty. It seems to me that this is a problem here that has got to be worked out.

Mr. Mentz. I am familiar with that provision, Senator Baucus, and if it turns out-- As you know, the British have agreed not to take any action until, at the earliest, January 1, 1987; and any action that they took would not be retroactive before that.

If any action were to be taken, I might tend to see the U.K. treaty a little bit closer to the way you do.

Senator Baucus. Well, let's make it equal. Let's pass it and not worry about when we make it effective.

Mr. Mentz. Well, let's not make it that easily.

Senator Baucus. That is a level playing field with the U.K.

Ms. Pearson. Mr. Chairman, we are on 102, number 5. Foreign investment in U.S. business assets.

Under current law, capital gains is imposed on the sale of U.S. real estate owned by foreign persons.

The chairman's proposal extends capital gains tax to the sale of stock by a foreign person in a U.S. corporation and gained on the liquidation of foreign controlled U.S. corporations.

Senator Grassley. Mr. Chairman?

The Chairman. Senator Grassley?

Senator Grassley. I haven't had a chance to review the arguments behind the chairman's proposal for expanding the foreign investment real estate property tax act; but I am sure that there will be an attempt to modify even existing law in this area.

The Chairman. Yes. One of the members has talked to me about it.

Senator Grassley. What I want to do right now is remind the committee of why the Act was passed in the first place. Part of it dealt with the movement toward foreign investment in agricultural lands, and part of a movement at that time to discourage that.

But we have never prohibited, as foreign countries have, the investment of foreigners in agricultural real estate like other countries have Americans' investment in their countries.

But what we found in 1979 or 1980 is that foreign investment could take an election under the then existing law.

And if they took that election, they could then avoid the capital gains tax, if they sold their property. If they handled it just right, then they would have that tax advantage that Americans didn't have.

And all we were trying to do in this Act that was passed in 1979 or 1980 was to see that individuals in America--or foreigners investing in America didn't have a tax advantage over an American. And we accomplished that.

Now, in addition, withholding was brought up later on as a real enforcement of that. I support that although I guess maybe that has some legitimate arguments against it.

But as long as the basic law maintains it the same and we have equality between Americans and foreigners, I think that is good and that ought to be maintained.

But when I really came to the conclusion that we did the right thing in 1979 or 1980 was later on. I think it was during the 1984 tax bill. We had people from The Netherlands, The Antilles that were lobbying those of us who had promoted it.

Their question was: Wouldn't we be for some modification because, as a matter of treaty equity, and that there was the implied threat that foreign nations would change their treaties and deny Americans certain investment advantages in their countries, if we didn't change this Tax Act?

Well, when people from The Netherlands Antilles started talking to me about this, you know, that is exactly what we were trying to get at in 1979 and 1980: Close some of those investment havens, tax havens--whatever you want to call them --loopholes that foreigners had that Americans didn't have.

And that is really all we were trying to do. I even had an opportunity to visit with some people from London about the necessity for changing it.

I don't know, beyond real estate, the justification for it, as the chairman might want to do. But I do feel that where you have a finite quantity, like real estate is, that foreign investment doesn't create jobs in agriculture, like maybe foreign investment does create jobs in nonagricultural investments.

And in fact, it displaces American jobs in agriculture. So, I just wanted the committee to be aware of where I was coming from on this and the fact that I would resist efforts to change the law that was passed in 1979 or 1980.

The Chairman. As a matter of fact, the law didn't even work. If the purpose was to discourage foreign investment, the investments continued right on even with the law in real estate, and has continued on up.

Senator Grassley. Maybe I had better clarify then something. I want to make it clear that we were not trying to discourage investment. All we wanted to do was get equity of treatment between Americans paying capital gains taxes and foreigners--that they would have to pay that capital gains tax, too.

The Chairman. Go ahead, Mary Frances.

Ms. Pearson. All right. Item 6, page 103. We are imposing a tax on interest paid to foreign persons. This tax would be imposed on foreigners who have interest paid to them by U.S. persons and it will go into effect in 1992.

However, in the case of treaty shopping, it goes into effect now.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee?

Senator Chafee. As you recall, this change was made as a result of a great interest that Senator Bentsen and I had in this whole area in which the original tax, as you recall, was 30 percent.

And at the time, an escape route was used through The Netherlands Antilles, so they weren't paying the tax. Thus, there wasn't a legitimate entry into the Eurodollar market except via The Netherlands Antilles.

And that route was cut off, and the route was proposed and went into effect via the reduction of the 30 percent withholding tax.

And now, to impose a five percent withholding tax, to me, and with The Netherlands Antilles cut off because of changes we made in the law, means that we are just closing our corporation and our Government, Mr. Chairman--our Government--from access to the Eurodollar market.

And the inevitable consequence of this is to increase interest rates by a margin of who-knows-what because there is less access to borrowers.

And I have great trouble understanding the rationale for this, and indeed, will vigorously move to eliminate it unless--

The Chairman. The rationale is the same as Senator Grassley said before. If you loan me $100.00, I pay you 10 percent interest; you pay a tax on it.

Maria, who is a French citizen, loans me $100.00. I pay her 10 percent interest; she doesn't pay any tax on it. And that isn't fair.

Senator Grassley. No, that isn't the way it works. Treasury--Mr. Mentz, perhaps you can go ahead and describe it, particularly with the access of our Governments and our corporations.

Mr. Mentz. Yes. I think that it doesn't work that way.

The Chairman. Aren't you going to go along with the chairman because he wants this?

(Laughter)

Mr. Mentz. No, this is one that the Treasury will not go along with the chairman. In fact, this is one that the Administration feels particularly strongly on.

What this provision will do will basically make it impossible for U.S. borrowers to tap the Eurodollar market.

Presently, the Eurodollar market is a pool of dollars on deposit outside the United States; and U.S. lenders, including the U.S. Treasury, can borrow in that market.

If there is any withholding tax, the withholding tax is imposed on the borrower, not the lender. The lender never pays withholding tax in the Eurodollar market, and that is the principal reason that, as Senator Chafee says, this will make it not possible for U.S. borrowers to borrow in the Eurodollar market.

By reason of the five percent tax, there will be a small differential that the U.S. borrower will have to make up, and he will have to make it up by paying a greater amount of interest to the lender; and that interest itself will be subject to the five percent tax, and there will be enough of a differential as a result of that five percent tax to make it impossible for U.S. borrowers to borrow in that market.

That will mean that U.S. companies and the U.S. Government and U.S. agencies will have to borrow in the U.S. market at higher interest rates. It will push up interest rates in the U.S. slightly.

And the effect will be counter to the position that the Treasury has advocated for really over 20 years in keeping the Eurodollar market open.

It is definitely not open unless it is open directly.

You are exactly correct. The Netherlands Antilles line is absolutely closed.

The Chairman. What will be the effect on the value of the dollar if it is slightly more difficult for the foreigners to invest because they have to pay the higher interest rate, or have to pay interest at all?

Mr. Mentz. The foreigners won't invest. There won't be transactions accomplished. In other words, they just won't happen.

Now, whether a slight increase in U.S. domestic interest rates is going to affect the value of the dollar, it may; I don't know. But the basic fallacy here is thinking that this is going to put a little tax on foreigners. It is not going to put any tax on foreigners because foreigners aren't going to take interest unless it is net of withholding tax, and U.S. borrowers are not going to borrow net of withholding tax.

So, these transactions are going to be shut down.

To summarize, the Treasury opposes this provision.

Senator Chafee. Not only that, but even though you might show here a revenue loss if we eliminate the five percent withholding suggested by the chairman, that is not really accurate because the U.S. Treasury is going to have to pay more for its borrowings.

After all, the U.S. Treasury is by far the largest single borrower in the world. And if the U.S. Treasury has to pay a couple of points more for its borrowing, the effect of the cost to the U.S. Government is going to be way more than whatever the revenue figure loss here is.

Mr. Chairman, it isn't as though we haven't been down this route. We know what we are talking about because we saw it. It is like infant baptism. I believe in it because I have seen it.

(Laughter)

Senator Chafee. And we have seen this. Nobody used it because they all went through the lesser Antilles. We didn't get any revenue at the 30 percent mark.

Now, that has been cut off. We are not going to get any revenue under the five percent withholding.

The Chairman. Well, then, where do we come to the $300 million estimate?

Mr. Brockway. Our assumption is that you will, in fact, raise revenue. It is similar to whether or not the Government would raise money if it issued tax-free bonds in the United States.

Its interest costs would go down, but in the aggregate, you would lose money from the lower taxes. And we are assuming that you are going to pick up very little revenue in this because we are basically assuming the cross-border flows of capital will continue.

If you assume that no foreigners will lend into the United

States as a result of the five percent tax, you then have to ask yourself what is going to happen to that money that foreigners have.

If you don't have that same capital flow into the United States, that necessarily means you are going to have an improvement in your trade balance because they even out to zero mathematically. They have to.

So, the other alternative, and the one we assume, is that the money largely will continue to flow on a cross-border basis and other directions, but there will also be some shifting where U.S. people will become the lenders to U.S. businesses, and the foreign lenders will become lenders to foreign people.

But the amount of money we are talking about is very small compared to the aggregate amount of money that would be potentially subject to the tax on these investments.

So, the estimates have been very greatly discounted. If we had assumed that all transactions--existing transactions--would go forward but would be subject to the withholding tax, the revenue effect would have been much, much larger.

So, we are assuming a very substantial discount; but still think it can be positive as most any time you decide to tax some income or not.

Senator Chafee. Mr. Chairman, what Mr. Brockway is saying is that there is going to be a lack of access to a large sum of money because of this, and thus, inevitably, because of the laws of supply and demand, the interest rates are going to go up.

Now, how much? Who knows? How many points? We don't know. But when you have the same amount of borrowing demand going to a restricted market, obviously the rates go up.

And I think one of the thrusts you followed here, Mr. Chairman, and I think we have all followed, is to do all we can to bring interest rates down for a whole variety of reasons, not just homebuilders, not just construction, but the value of the dollar.

So, I think it is just a great mistake to propose this, and I will move to eliminate it.

The Chairman. Go ahead, Mary Frances.

Ms. Pearson. Number 7, page 103 is a compliance provision. Foreign corporations are presently required to report their assets. We extend it to a foreign person who owns the foreign-controlled corporation.

Number 8 on page 104. Presently, foreign persons who earn wages or investment income in the United States are subject to a tax. We now apply that tax to foreign persons that are formed as part of a domestic partnership.

Number 9. We take income of foreign governments; and if they own stock in a U.S. corporation and the stock pays a dividend to the foreign government, the chairman's proposal will tax that.

The Chairman. All we have done there is codify the Treasury rule, isn't it?

Ms. Pearson. Yes, and we expand it to include controlling stock interests in a corporation.

The Chairman. All right.

Ms. Pearson. Number 10. Under Section 482, the Treasury can allocate a proper price to a product if the taxpayer hasn't done it.

This is a rule of clarification that importers could not claim a transfer price for income tax purposes that is not higher than would be consistent for Customs value.

Number 11, dual resident companies. Right now, a corporation can be a resident of both the U.K. or Australia and the United States, and that corporation gets a double deduction, both from the United States and the U.K.

We denied the deduction if they have taken it in a foreign country.

Mr. Mentz. Before you leave that one --

Senator Chafee. Are we on 11?

Ms. Pearson. Yes, we are on 11, sir.

Mr. Mentz. Go ahead, Senator Chafee.

Senator Chafee. I was curious what Treasury thought of this.

Mr. Mentz. This is a little troublesome. The way that the proposal works, it would only deny the deduction in the case where you have the parent as a foreign corporation. In other words, it is basically targetted to the U.K. parent that has a U.S. subsidiary that is managed and controlled in the U.K., but not the other way around where you have the U.S. parent--these are called link companies--link or dual resident companies--if a U.S. company has a link, and the link is managed and controlled in the U.K. and invests in the U.K. in that way.

Because you have a different rule for foreign controlled and U.S. controlled, I think there is a pretty clear problem of discrimination under the U.K. treaty.

And because it is a one-way street, it sort of invites retaliation or invites the same treatment, it always seemed to me at least that U.S. rules are right here in allowing to tax a U.S. company on worldwide income and allow it deductions.

If the U.K. wants to allow that company to be included in its consolidated return or consolidated concept--just like a consolidated return--it doesn't seem to me that it is up to the U.S. Government to change that.

The Chairman. But you have a situation then where the company can, in essence, take 200 percent of its deductions.

Mr. Mentz. It basically takes the deductions on the U.K. return and the U.S. return. That is the way a link company works, Mr. Chairman. That is right.

The Chairman. And it is being used on take-overs, isn't it?

Mr. Mentz. Well, it is always used in acquisitions, and it is used by a U.S. company that wants to invest in the U.K. It is used by a U.K. company that wants to invest in the U.S.

I forget which way-- There is a double link going in one direction, but I can't remember which direction that is. But anyway --

The Chairman. Well, it makes companies a wonderful target for take-overs if they can get a 200 percent deduction of their expenses.

Mr. Mentz. It is interest expense. Well, yes.

Ms. Pearson. Yes.

Mr. Brockway. Yes, you would set up a financing company that would be a resident in both, and it would just generate losses. You know it is going to have losses, and so, you take those losses and offset it against income in both countries.

So, you get the interest deduction in both places.

I should point out also that Treasury raised the issue of the way it is set out in the spreadsheet, that it might be nondiscriminatory because it is looking solely at who the ultimate parent is.

Doing some thinking about that, I think technically the way it might be implemented is saying that the rule would apply where the foreign corporation was one that was not a U.S. corporation or a controlled foreign corporation.

That is, another corporation whose income would ultimately be subject to tax. That would have the same practical result as the way the rule is summarily stated in the spreadsheet, but it would--I think at least as a technical matter and probably a substantive matter--solve the nondiscrimination problem.

Mr. Mentz. Yes. The nondiscrimination problem is our biggest problem with it.

Ms. Pearson. Number 12 on page 104. When a foreign corporation is located in U.S. corporation and it takes an undue amount of interest deduction, i.e., over 50 percent of their income, we limit the amount of interest deduction taken over 50 percent of the income.

Mr. Mentz. This one may be a problem for us as well. Again, you have, or you may have, a treaty override problem. And you also have a situation here where it is not just interest paid to a foreign parent, which I take it is the prime target here; but if you had a U.S. company that had a borrowing through The Netherlands Antilles--a Eurodollar borrowing--and if that U.S. company happened--General Motors or any U.S. company--to have a loss in a particular year, it would lose its interest deductions, as I read this proposal, which I think is something that Treasury has problems with.

Am I reading it correctly, Mary Frances?

Ms. Pearson. Yes. But Mr. Chairman, the proposal, historically and under the Administration and the House bill, the only imaginative way they raise taxes is on the backs of U.S. taxpayers.

The chairman's proposal has sought to broaden the base and try to impose it in the case where U.S. taxpayers are paying that tax, and through certain devices such as dual resident companies and loading up all your expenses in the U.S., foreign taxpayers are able to avoid paying their fair share of U.S. tax.

And I just would like to make that point.

Mr. Mentz. Well, I am suggesting, though, that you are also taxing General Motors.

Mr. Brockway. Mr. Secretary, if I could? Technically, I think the way this works: The hypothetical you are talking about where the controlled foreign corporation is a financed subsidiary, that income is subpart (f) income, and it is currently subject to tax.

So, that would not apply here. This would pick up, if it was a payment to a foreign-owned corporation where the income wasn't currently subject to tax, but where it was currently subject to tax, so the taxpayer isn't getting a deduction in the U.S. return, but then tax exemption on the income in that situation.

The hypo you point out--the finance sub--this rule would not apply to. So, I don't the GM case would be effective here. It is only where there is a deduction in the U.S. return paid to a related party where the income is not ultimately to come back into the United States return.

Mr. Mentz. Okay. So, it is only the treaty override problem that I am worried about here.

The Chairman. Shall we give you a stretch-out?

Mr. Mentz. Thank you.

Ms. Pearson. Mr. Chairman, we are now on page 105 in the foreign currency exchange gain or loss rules. Under current law, there is no real rule on how to translate foreign currency gain or loss.

The President proposed rules to pin this down for the taxpayers that had some certainty.

We generally adopt the President's proposal on those rules, and taxpayers seems to be in agreement with a firm set of rules. That is it.

The Chairman. Any other questions?

(No response)

The Chairman. We will come back then at 1:30 and do, hopefully, accounting, depreciation, and employee benefits.

(Whereupon, at 12:01 p.m., the hearing was recessed.)

AFTERNOON SESSION

(1:40 p.m.)

The Chairman. The committee will come to order, and hopefully we can do some explanation until sufficient members arrive for a quorum.

I want to start on employee benefits. John, you've got a request from Senator Heinz.

Mr. Colvin. Yes, Mr. Chairman. Senator Heinz requested that the non-discrimination rules for health insurance on page 160 and 161 remain open until the committee takes up pensions.

The Chairman. Just the non-discrimination rules, nothing else?

Mr. Colvin. That's right. The other pages in employee benefits he has no objection to acting on this afternoon.

The Chairman. And I know that Senator Chafee has an amendment on employee awards and also one on the life insurance provided by employers. Do you know of any other amendments?

Mr. Colvin. No, sir.

The Chairman. Do either Senators Mitchell or Pryor? George, do you have any amendments on employee benefits?

Senator Boren. No, not for me, Mr. Chairman.

The Chairman. All right.

Do you have any amendments on employee benefits?

Senator Boren. I have but one to offer.

The Chairman. Yes, on depreciation.

Senator Pryor. That's an employee benefit.

(Laughter)

Senator Boren. It creates a few jobs. And I am ready to offer that any time you want me to.

The Chairman. Well, if I can, I'm just going to try to wrap up employee benefits. What we will do, though, I think, is go to depreciation, because there are only two amendments to consider, one of which is acceptable to me, the Chafee Amendment on Prizes and Awards. He is at a luncheon right now at the Japanese Embassy and will be back shortly.

So I think we will set these aside. We have only those two. And go on to depreciation.

Senator Pryor. Is this the area, Mr. Chairman, where Senator Grassley has an amendment.

The Chairman. On what?

Senator Pryor. Well, let's see: treating farmers and small business self-employed persons the same as your majors.

The Chairman. Oh, that's on health insurance, where it allows individuals to deduct half the cost of the premiums. Of course, all businesses, if they are incorporated can deduct all the cost of the premiums now; but the self-employed cannot deduct any of it. That was Senator Grassley's amendment, and it is in the Chairman's draft to allow them to deduct half. I haven't heard of anyone who wants to knock it out.

Senator Mitchell. Mr. Chairman, the staff is working on an amendment that I am considering, regarding the discrimination rules. And I will have that ready for tomorrow. It may not be a problem for you.

The Chairman. Is this on the pension part, or employee benefits, or both, or what?

Senator Mitchell. Employee benefits.

The Chairman. All right. It bounces off of me, because my hunch would be that you and I may be in accord on it, I would think.

Senator Mitchell. I had better wait until I am prepared to do that.

The Chairman. All right.

Let's move over, then, until Senator Chafee comes, to depreciation.

Why don't you go ahead and offer it? We have to have seven in order to have a quorum, and we will have that shortly. But why don't you offer your amendment, David, and talk about it?

Senator Boren. Well, the amendment that I am offering is one which would simply move refineries back into the five-year category where they are presently under current law.

We have had a real problem in terms of a reduction of refining capacity in this country over the past five or six years. I think many of us have had experiences of numerous refineries that have gone out of business in our states, and we have had several close in the State of Oklahoma.

The actual refining capacity is down by about 30 percent in the United States over the past five or six years. The ability to keep pace as we have changed chemical content, and environmental regulations, and the rest, and the need to modernize our refinery capacity in this country is very, very strong.

I think when we consider energy independence and the national security needs, this is an area in which we certainly have to give full consideration.

We are in some danger of approaching the time in which we would not have the ability to continue to refine our current needs, and in addition thereto have the capacity to refine product coming out of the Strategic Petroleum Reserve as well in time of national emergency.

Other countries are more and more moving to a situation in which they try to sell us refined product instead of crude oil, and they have a movement more and more toward the building of offshore refineries.

So, for us to be able to compete and be able to have a level playing field and be able to keep the cost of capital in bounds, I think it is extremely important that we try to maintain current law in this area.

There is, I would tell the committee, some not insignificant cost to this amendment; I think it is in the neighborhood of $7-800 million. I'm sure Treasury can give us that exact estimate. But I do feel strongly that, in terms of deciding the depreciable life of various kinds of assets, as we have been discussing over the past several days in the committee, that refineries deserve to be put back into the five-year category.

The Chairman. What was the life prior to the '81 Act?

Senator Boren. Let's see. The five-year class was a 16-year ADR life, but it was a five-year class.

The Chairman. You mean it got a five-year depreciation prior to '81?

Senator Boren. I think that's correct.

Mr. Brockway. In 1981 it went to five years. Yes. Before that it was a 16-year ADR class, which would have meant you could have depreciated it over a period that was 20-percent shorter than that, so roughly 13 years would be the quickest you could depreciate it.

The Chairman. Is the useful life of a refinery 16 years?

Mr. Brockway. The way ADR was constructed, that would mean that 16 years would have been the low average -- the useful life would have been something more than 16 years, based on how we constructed that.

Senator Boren. In spite of the fact that we went to five years in 1981, we have still have a contraction of the industry in this country, the refining industry.

I think, again, when we talk about -- I think steel is under a five-year period in this proposal, is it not? Under the proposal before the committee, that is now adopted?

Mr. Brockway. Yes, steel is a 15-year ADR class, so that would get a five-year --

Senator Boren. Well, it is a five-year.

Mr. Brockway. That is correct.

Senator Boren. I would think that there would be a parallel in terms of equity in the kind of asset we are dealing with. There's a strong argument that it should receive the same kind of treatment.

And EPA retrofitting has been another requirement that has been added to the problems of domestic refining.

I can just say that I know in our part of the country we have lost significant refining jobs, and more and more we are seeing our refining capacity move offshore. It is a fact that our potential refining capacity has declined some 4 million barrels per day over the past five or six years.

The Chairman. Under the Roth-Baucus proposal, you said that steel has five years?

Mr. Brockway. Steel would have five years, because it is a 15-year life.

The Chairman. And had it had a 16-year life, what would it have had?

Mr. Brockway. It would have then had a 10 year.

The Chairman. That was the switching point?

Mr. Brockway. That's the switching point.

The Chairman. Was the ADR-15 versus the ADR-16.

Senator Boren. Which is the very same thing that refineries were caught in, but steel has moved back into the five-year category.

Mr. Brockway. Well, I think the line originally drawn was between 15 and 16, so that under the Chairman's proposal and then as modified by Senator Roth it simply is that steel would have been on the shorter category.

Senator Boren. Moved back into five years. Well, I am just suggesting that we treat refineries the same way.

The Chairman. Does Treasury have a comment?

Mr. Mentz. I don't think I can add to your store of knowledge, Mr. Chairman; it is all on the table.

The Chairman. And what is the cost? Eight hundred million?

Mr. Brockway. Again Senator Roth's package with the 200 percent declining balance, we are estimating that it's point-nine. It would have been point-eight under the original package.

Senator Boren. Point-eight under the original package?

Mr. Brockway. And point-nine here.

The Chairman. Further discussion?

At the moment, David, we don't have enough people to vote.

Further discussion on this issue?

(No response)

The Chairman. Well, let's put the amendment aside for the moment, then. Who else has amendments? George?

Senator Mitchell. None, Mr. Chairman.

The Chairman. Any others? David?

(No response)

The Chairman. What amendments do you know for sure -- John, or Greg, or David -- that the members are going to offer?

Mr. Wilkins, do you have any that you know of?

Mr. Wilkins. No, Mr. Chairman, I don't.

Mr. Brockway. I don't know of any for sure.

The Chairman. The reason I ask, I have had numerous suggestions -- sometimes the members write out something on a piece of paper and give it to me in handwriting, and that's the last I hear of it. I don't know if they follow up on it; in many cases they don't, and in some cases they do. So, when I ask you what they have in mind, I have some thoughts but they are pretty sketchy.

Mr. Brockway. Senator Durenberger had raised, in markup, the question -- a similar issue to this on oil refineries --

of whether grain processing --

The Chairman. I think he asked to reserve that. He could not be here today. As I indicated, what we don't finish today we will put over to another session, but it will not be tommorrow. I am going to move that toward the end, and we will try to finish up and stay reasonably on the agenda for what we have the rest of this week. He indicated he will be bringing up I think it was five years for food processing factories, wasn't it?

Senator Boren. That is correct. Senator Durenberger I know intended to do that, food processing facilities, and he was tied up in the same Intelligence Committee meeting last week. We both had those amendments, and I do know he has a definite intent to offer that.

The Chairman. Further discussion on any depreciation amendments?

(No response)

The Chairman. Well, let's see if we can take any accounting amendments. Let's move over to accounting for a moment.

(Pause)

The Chairman. Are there any accounting amendments to be offered?

(No response)

The Chairman. Senator Armstrong is not here today. He has indicated he will be offering one, I think on cash accounting, unless he changes his mind. And Senator Durenberger has one on the department store credit cards and revolving credit sales.

David, we took care of yours on the long-term contracts, as I recall.

Senator Pryor. Mr. Chairman, I don't think it was taken care of. I am hopeful that the Department might accept this amendment. This is on the installment credit sales of land.

The Chairman. Oh, is this the one that you do not need if we keep the builder bond provision the way it is?

Senator Pryor. I think that is correct, Mr. Chairman.

The Chairman. Why don't you hold that, then, until we get to the builder bond issue, and see how that is disposed of?

Senator Pryor. That is agreeable.

The Chairman. Because there is no point in offering it if the draft is not changed.

Well, Senator Symms, do you have an amendment in the accounting section?

Senator Symms. Excuse me, Mr. Chairman. What did you say?

The Chairman. Do you have an amendment? I was under the impression that you might have an amendment in the accounting section.

Senator Symms. As a matter of fact, I do, if I can find it.

(Pause)

Senator Symms. Mr. Chairman, the amendment I have is, there is a provision in the 1984 law which requires the recognition of all 1245 gain that is ordinary income on depreciable personal property in the year of sale. And this provision has made it impossible to sell some of the high lift farm operations in Idaho where there is a lot of money invested in pumping and irrigation equipment.

These farms are almost always sold under a contract, with the farmer carrying the contract. The contract under normal circumstances has an element of gain from the sale on which the tax must be paid on installment basis. After the tax is paid, the balance of the payment is then available for living expenses to the farmer in the retirement years.

But the provision in the '84 law requires the payment of the tax on the income before the cash has been received.

So, the circumstances are, and it is not too unusual to create a tax liability of as much as a quarter of a million dollars with cash from a down payment of only $50,000 down, on the farm. And very few of these people -- most of them are selling, just trying to get out before they have to go into some kind of a bankruptcy situation, and it is just impossible for them to make the payments.

So, my amendment doesn't change the character of the income or the amount of income, it merely allows the tax to be paid as the money is paid. It is not a new concept, but it just puts this type of transaction in the same position it always had been prior to '84 law. And the revenue estimates from the Joint Tax Committee for the provision is less than $10 million annually. In other words, what the amendment would say is that, if a farmer sells a farm on a contract, and a certain amount of the value of that is pumping equipment, irrigation equipment, that he would not have to make payments to the IRS until he actually receives the money. As simple as that.

John, do you want to make any comment on it or any further explanation?

Mr. Colvin. I just wanted to say that Senator Symms notified us several weeks ago of his interest in this amendment, and the statement of the revenue estimate is correct: it is less than $50 million over the five-year period.

The Chairman. Well, it seems to me the amendment has merit. Mr. Secretary?

Mr. Mentz. I would have to oppose the amendment on behalf of the Treasury -- not because I am unsympathetic to the plight of the individuals that Senator Symms described.

But you go back to the '84 Act, I wasn't here in '84 but my understanding of the reason was of requiring recapture of depreciation without deferral, even under an installment sale method. The theory was that the purchaser was taking a new basis and was getting the higher depreciation immediately once that sale took place.

I think the sort of equity to it or the balance to it was, "Well, okay, if the purchaser is getting the higher basis to write off, there would be correspondingly the depreciation recapture required at the time of the installment sale, even though the rest of the gain is deferred." And that applies for all installment sales.

It is very hard to find a principle that excludes farmers or irrigation equipment and doesn't also cover -- you know, there is probably some kind of oil equipment that would also be covered. I am sure each member of this committee could come up with a special category that ought to be exempt from this recapture rule. I think once you do that you are going to erode the '84 Act, and before you know it your revenue is going to be substantially more than $50 million.

Senator Symms. Ten million.

Mr. Mentz. Over the budget period.

Senator Symms. But this exception is for farm irrigation equipment, and it "shall not apply to an installment sale of any property which is part of a system to irrigate land used for farming purposes within the meaning of this section." I mean, it is a very narrow description.

Mr. Mentz. Yes.

Senator Symms. But the reality of it is that it just stops people's ability to sell their property and dispose of it. It seems to me like the prudent rule should be that, until a person actually receives the money, they shouldn't be liable for the tax. How can you argue with that?

Mr. Mentz. Well, I think the way to argue with it, just to state it again, is, if you have that rule for irrigation, why shouldn't the same rule apply to oil-drilling equipment?

Senator Symms. Okay. Let's just say, for example, the fellow sells the farm in good faith to an operator who buys it in good faith, and after about the second or third year he finds out he's got the farm back, the person says he can't pay for it, that farm prices are too depressed, or whatever. So then, the IRS would then owe that person back taxes, correct? How would you handle that?

Mr. Mentz. But that is no different in a farm case versus an oil rig versus any other kind of equipment, Senator, and I think that decision was made in the '84 Act across the board, and I think there is a rationale to it.

Now, if you want to revisit the whole principle, I think you are talking about a lot more money. And I am unclear. Mr. Colvin, did you say $50 million over the budget period?

Senator Symms. Ten.

Mr. Colvin. My understanding is that it is less than $10 million per year and less than $50 million over five years.

Senator Symms. Oh. Okay. Excuse me.

The Chairman. Further discussion?

Steve, we are waiting for seven members before we can vote on any amendment. We don't need a quorum, but we need seven.

Any other amendments?

(No response)

Senator Pryor. Are we open for a question on the completed-contract method of accounting, Mr. Chairman, while we are waiting for a quorum? Is that proper? We are not ready to vote on Senator Symms' amendment, are we?

The Chairman. No, because we don't have seven people here. We are open for it. It is an issue of immense concern to Senator Danforth, and if it is more than a question I would just as soon you would delay it.

Senator Pryor. Well, I will just wait a few minutes.

The Chairman. But why don't you ask the question?

Senator Pryor. I was just going to ask the Department what might be the revenue effect of retaining the present law for contracts of less than 36 months, or contractors with less than $25 million in receipts?

The Chairman. Was that "or"? Thirty-six months or $25 million?

Senator Pryor. Or $25 million. I wonder if we have a figure on that?

(Pause)

Senator Pryor. The second question I might ask, if I might, at this same time, because they might run across it: What would be the revenue effect of exempting all contracts of two years or less? So, we are looking at a difference there in the 12-month period.

The Chairman. Regardless of the size of the contractor?

Senator Pryor. Right.

Mr. Mentz. When you say "exempt," you mean exempt from the capitalization rules, Senator Pryor?

Senator Pryor. Exempt from the present law, right.

The Chairman. Do you mean keep the present law?

Mr. Mentz. You mean keep the present law, not have the more stringent capitalization rules apply?

Senator Pryor. Correct.

Mr. Brockway. Did I understand your question, Senator? One, what would happen if you modified the Chairman's proposal so that real property contracts of two years or less were exempted? That would be a revenue loss of point-nine over the period.

The Chairman. You said three years, I think, didn't you?

Senator Pryor. I used 36 months or less.

Mr. Brockway. At 36 months, that would be $1.8 billion.

Senator Pryor. Now, this is in the area of completed contracts.

Mr. Brockway. Just for real property construction contracts.

The Chairman. Is that what you meant to limit it to, David, was real property construction?

Senator Pryor. You say a $1.6 loss over --

Mr. Brockway. I said 1.8 for contracts of three years or less.

Senator Pryor. All right.

And then do we have any sort of figure on what would be the revenue effect of exempting all contracts of two years or less with no $25 or $10 million figure, just all contracts? And this is all real property.

Mr. Brockway. Senator, at the moment the only number I have is exempting all contracts, all real property contracts. In other words, the defense contracts wouldn't be exempted.

Senator Pryor. Not defense, but real property.

Mr. Brockway. Just real property contracts, that would be point-nine over the period.

Also, maybe I misunderstood your question, but the three years -- when I gave you the 1.8 billion for three years I was referring to all contracts under three years, without any $25 million cutoff or $10 million cutoff.

Senator Pryor. Just working on the month times 36?

Mr. Brockway. Moving the month, but exempting all of them regardless of size.

Senator Pryor. All right. We are going to do a little calculation. We may revisit this.

The Chairman. When you refer -- I want to make sure we are talking on the same wavelength -- to a real property contract, do you mean building a building, building a dam, highway construction, and that type of thing?

Mr. Brockway. That is correct, Mr. Chairman. There are essentially two types of transactions that are covered by these long-term contract rules: One, the Defense Department contracts, and then others.

The Chairman. Where you are turning out personally, but you are turning out great quantities of them over a long period of time?

Mr. Brockway. That is correct. And then the large bulk of it is constructing dams, office buildings, and that type of thing.

The Chairman. Other discussion?

(No response)

The Chairman. Well, then I think for the moment we will just wait until some of the members show up.

Senator Pryor. Mr. Chairman, I might just place into the record that I mentioned a while ago the figures on refineries in regard to my refinery amendment. In 1981, according to the U.S. Energy Information Administration, there were 315 operating refineries in the United States, nine in the status of shutdown being worked on, with a total of 324, with 18,051,000 barrels a day of capacity.

In 1985, we were down to 199 operating, 24 in a shutdown stage, for a total of 223, with a total capacity of 14,360,000 barrels per day. I just insert that in the record as giving the exact figure that I mentioned in general terms a little bit earlier.

The Chairman. I might add, so the committee can realize how fast we can act, we had the hearing on Secretary Mentz late last week, and on Friday he was confirmed as Assistant Secretary.

Congratulations, Mr. Secretary.

Mr. Mentz. I was confirmed?

(Laughter)

(Applause)

The Chairman. Because of the absences, the vote wasn't that close.

(Laughter)

Senator Pryor. Is this done under a transition rule, Mr. Chairman?

The Chairman. His confirmation?

Senator Pryor. Effective date, or something?

(Laughter)

The Chairman. Retroactive effective date.

(Pause)

The Chairman. All right, let's start again. Senator Moynihan is here, Senator Chafee is here. I know that Senator Chafee has at least two amendments in the employee benefit section.

Senator Chafee. Mr. Chairman?

The Chairman. Go ahead.

Senator Chafee. Mr. Chairman, this deals with the employee achievement awards. And I am not sure what page that is on.

Mr. Colvin. Page 165, Senator Chafee.

Senator Chafee. Thank you.

Mr. Chairman, what the Chairman's proposal does, and also which conforms with the President's proposal, is that it says "All prizes and awards," with a few exceptions, "must be taxable." And that really means the end of the awards, because you are not going to give somebody an award for meritorious achievement and then say to him -- you build up all this good will, and the award is a nonfungible award; it is an award of a pen and pencil award, or some such, a clock or something to that effect, with his name engraved on it, and then say, "That is splendid going. And by the way, your income has been increased by $200, and you will now be taxable." Whatever good will you build up with the presentation is more than overcome by the ill will that you incur when he finds that this chintzy gift is taxable.

(Laughter)

Senator Chafee. So, his morale is diminished, and your good will has vanished. So therefore, there wouldn't be any gift, and what you would achieve by all of this would not be --

The Chairman. You mean we wouldn't get any income, then?

Senator Chafee. You wouldn't get any income. You get to the heart of the matter, Mr. Chairman. That's it.

(Laughter)

Senator Chafee. Now, what we have got here is a compromise proposal. It is not everything I would like, but I think the staff has it, and why don't you go ahead and outline it.

Senator Moynihan. Mr. Chairman?

The Chairman. Senator Moynihan?

Senator Moynihan. Could I just join with Senator Chafee in this matter? This comes under the heading of "Old and Established Patterns of American Organizational Behavior," and something you like.

The Chairman. There is a certain niggling smallness in my proposal, is what you are saying.

Senator Moynihan. Yes. It is not like you to not want to have somebody get a gold watch. I mean, your day will come.

(Laughter)

The Chairman. Not this year, I hope.

(Laughter)

Senator Moynihan. No, no. I mean the proposal Senator Chafee has is quite limited, but it keeps in place a well-recognized, long-established, not abused -- it takes 40 years to get those awards.

The Chairman. In the spirit of comedy I would be willing without further explanation to suggest that we accept the amendment.

Senator Chafee. I press it no further, Mr. Chairman.

(Laughter)

The Chairman. Is there objection to accepting it?

(No response)

The Chairman. Accepted.

Now, you have a second amendment.

Senator Chafee. Yes. I think for the sake of simplicity, why don't you accept this one, too?

(Laughter)

The Chairman. On occasion you have to make a choice between simplicity and fairness.

Is this the life insurance, employer-provided?

Senator Chafee. The life insurance of $50,000. What page is that on, do you know?

Mr. Colvin. The question of non-discrimination rules for life insurance?

Senator Chafee. No, no, no. I am looking for to eliminate the deductibility or the nontaxability of the $50,000. Life insurance.

The Chairman. In a nutshell, let me explain it. I don't think we need the page. At the moment the employers are allowed to provide a maximum of $50,000 of life insurance for their employees. The value of the premium is not taxable as income to the employee.

I think what Senator Chafee would do is make the value of -- it is a maximum of $50,000; that's all you can provide. I think Senator Chafee would make the value of the premium taxable income to the employee. Do I state it right?

Senator Chafee. Yes. Why don't I just review the bidding a bit? First of all, on the prior amendment -- that's p-r-i-o-r amendment -- Senator Heinz would like to be added as a cosponsor and indicate his interest in this matter.

Now, Mr. Chairman, we are dealing with the taxability of fringe benefits. The President, as you know, would have had them all taxable, I think with few exceptions. The Chairman's proposal has modified that totally, to stick with present law.

Let me just say this: As far as the taxability of fringe benefits -- I am not getting into any of the others, the health and retirement -- I think we have to think of -- you mentioned fairness. Many people do not receive these tax-free benefits, and the element of fairness clearly comes into play.

For the person who does not receive it -- and let's just stick to the matter I am talking about, which is the $50,000 insurance. Under the present law, an employer can deduct the cost of it, it goes to his employee, the employee does not count it as income.

Now, that is grand for the employee that has got it; but for the employee that doesn't have it -- and by the way I think we might acknowledge that life insurance is something that most people seek -- he has to go out and purchase it with after-tax dollars. Now, that's hardly fair.

I know, Mr. Chairman, we heard you speak many times here on the subject of tax-free fringe benefits that were achieving a social purpose, but with everything there is a limitation, and that is why I haven't discussed in any way the retirement benefits or retirement provisions nor the accident and health.

But it seems to me that here is where we might well draw the line.

Now, there is confusion. The employee is not going to have to pay the entire cost of the policy. Let's just for argument's sake say the $50,000 policy, and these are all term, is worth $300. Now, that doesn't mean that the employee pays $300 -- no, he doesn't. He pays the portion of that that is taxable. In other words, if he is in the 20-percent bracket he might pay $60 for that.

So I just don't want people saying, "Oh, it's going to increase his income tax $300." It's not.

Now, the whole objective of what we are trying to do here is to reduce the rates, and to pay for it, it is to be done by eliminating preferences or deductions or exemptions or credits, so that the whole thing will be tax-neutral.

Now, we are nowhere near that. And I think you recognize that as much as anybody does, Mr. Chairman. Indeed, to pay for the program that you have got, we have included in it a provision that is worth some $60 billion -- $63 billion -- and we are always talking five years here, which I think most of us recognize has no chance of prevailing. So, we have to get the money as best we can from a whole variety of places.

And therefore, I think this is a fair proposal. And I am particularly thinking of the people -- I have many of them in my state -- who don't get a host of tax-free fringe benefits.

The Chairman. Well, Senator, it is not just tax-free fringe benefits. Why should the steel worker in Gary, Indiana make more than the steel worker in Texas, because one plant happens to be unionized and the other one isn't? They both have the same education, are the same age, and one makes two or three or four dollars an hour more. Is that fair?

Senator Chafee. That is a person selling his services for what he can obtain. But the Tax Code isn't involved in that in any respect. The Tax Code doesn't say that we ordain -- we sitting here, these 21 males sitting here in this committee -- and say, "In Indiana you will pay $4 more than you will in Texas; we decree it." No, we don't. But we are decreeing that somebody gets a benefit here, tax free, that another fellow doesn't get.

The Chairman. No. What we are saying is that, if the Gary, Indiana steelmaker wants to provide $50,000 in life insurance for the employee rather than taxable wages, that that is permissible. And if he chose to provide it in taxable wages instead, and that made the wages of the Gary, Indiana steelworker infinitely more than the Texas steelworker, you have still what I think you would call an unfairness.

For the life of me, I don't see the difference. I am willing to accept the diversity in this country and the fact that people in Oregon make more money or less than somebody in Idaho, and they make less or more money than somebody in Texas. And I am not trying to force a uniformity on here.

I sense you are saying that the lack of uniformity is unfair.

Senator Chafee. No. I am saying, first of all, we must recognize that if the Gary, Indiana employer gives the insurance to the employee, that that is a benefit; that is a benefit beyond what it would cost the individual who had to pay for it himself.

In other words, the fellow in Texax, let's assume who doesn't get this insurance, isn't going to come out the same as the fellow in Indiana; the fellow in Indiana is going to be way ahead, because he is going to get something for which he only has to pay $60. Let's assume that the tax is $60 and the insurance costs $300. The fellow in Texas is going to have to pay $300 with after-tax dollars for this; whereas, the person who receives the benefit in Indiana, under the proposal I make, is going to pay $60.

The employer still has the chance to provide it, and indeed he can continue to deduct it. But I am saying that it is right for the employee to pay a modest portion.

The Chairman. Well, I would hope we would not start down the road in this bill -- I thought we had reached an accommodation with the Administration. The House has not taxed these, and it would be my hope that we would not start down the road of taxing them in the Finance Committee now.

Senator Chafee. Well, I know how you feel. Your views are on record going back many, many years. But what is the purpose of tax reform? It seems to me the purpose of tax reform is as much as possible to provide that those with similar incomes pay similar taxes. That is what it is all about. If we don't want it, we are wasting an awful lot of time here.

This is a strenuous markup schedule that you have got, and --

The Chairman. Well, that's why I think we ought to vote on this one and get on to the next one.

Senator Chafee. I've got 11 proxies in my pocket.

The Chairman. One of us is lying.

(Laughter)

The Chairman. Further discussion?

(No response)

The Chairman. Do you want a rollcall?

Senator Chafee. I don't see enough sentiment around here.

The Chairman. All those in favor of the amendment will say Aye.

(Chorus of Ayes)

The Chairman. Opposed?

(Chorus of Nays)

The Chairman. The noes appear to have it. The noes have it.

Are there any other employee benefit amendments?

(No response)

The Chairman. If not, why don't we move back, then, to your amendment on the oil refineries. You have a few more people here now.

Senator Boren. Mr. Chairman, having explained it previously I won't go back all over it, but it returns refineries to the category of five-year life for depreciation purposes, as it was in the 1981 law. It returns refineries back to current law. Otherwise, they will be moved from the five-year period to the ten-year period.

I would just repeat that I think it fair that we do so. It would give them the same treatment that steel is receiving. As I mentioned earlier, we are in a situation in which we have had a dramatic decline in our domestic refining capacity, from 324 total refineries in 1981 down to 223, a drop of over 18 million barrels a day capacity down to 14 million barrels a day capacity, and I think it is important that we provide this treatment.

The cost against the original package was point-eight, or $800 million, as has been explained by the Treasury.

I think that pretty well summarizes it for those who were not here earlier when we had a further explanation.

Senator Mitchell. Will the Senator yield?

The Chairman. Senator Mitchell?

Senator Mitchell. Do I understand you are suggesting that because the industry is having hard times, at least in part, that we should change the classification of depreciation?

Senator Boren. No, sir. I talked about this at the time that the Roth Amendment was offered, and I deferred from offering it at that time and agreed with Senator Roth that I would offer it as a separate amendment.

Under current law, refineries are in the five-year period. That is the practical effect of current law. Under the staff draft they moved to 10 years. And even under five years we have had a very significant decline, approximately 30-40 percent of our domestic refining capacity. And we finally will reach the point, considering the competition that we are receiving from foreign refineries, coupled with the need to retrofit, to meet EPA standards, I think we run a real risk of not retaining enough domestic refining capacity in this country in the future to meet an emergency need, to take care of what we have in SPRO in addition to our regular flow, if we had to do that. And I simply think it is sound national policy. Even at the five years we have had these declines, so I would certainly hesitate to see us make it worse than the current law as far as refineries are concerned.

The Chairman. With all deference to my good friend, I am going to oppose this amendment. I can make a good case for lumber mills at five years, and my hunch is that there is a good case to be made to shorten anything to a shorter period of time.

Up until 1981 the oil refineries, as I understand it, were depreciated over a 16-year basis. Mr. Brockway, tell me again. How long were they depreciated over prior to 1981? Oil refineries?

Mr. Brockway. The ADR midpoint was 16, so they could have taken as short as a 13-year life.

The Chairman. All right. We went to very, very short lives in 1981 on all kinds of equipment, including real estate at 15 years, and we are now having second thoughts about some of those.

In the drafting of the bill we extended those things to 10 years that had an ADR life of 16 years or more, right?

Mr. Brockway. That is correct.

The Chairman. I know that Senator Durenberger is coming with food processing, but I can see the inevitable process if we start to open up now on the depreciation of any asset. I have not asked this for lumber, but any one of us have it in our states, in an industry that is in trouble, and most of us can point to some major industries in our states that are in trouble.

Senator Mitchell. That is the point I intended to make with my question, that we had not previously adopted the standard in determining length of depreciation of the health of a particular industry at a particular point in time.

As we all know, our economic system is such that it is cyclical; not only does the economy go through cycles, but various businesses go through cycles in each state. I can think in my own state of the paper industry, the shoe industry, which have in some cases substantial capital investments and which are experiencing very hard times.

Senator Boren. Mr. Chairman, not to prolong the debate, I would just say that my state happens to rank well down the list in terms of refining capacity. The refining capacity of this country is spread very broadly across the country, and I do think it is an area where we change the status of steel back to five years in the Roth package. I think we are dealing with a similar situation here, and I think we should not close our eyes to the implications of what we need in our refining industry, maintain domestically, in terms of the national security of the country.

I think if we don't keep it at five years where it is now, we really will face an uphill struggle to maintain the minimum refining capacity we need.

The Chairman. Further discussion? Senator Chafee?

Senator Chafee. Rr. Chairman, what is the life, the expected life, of a refinery? Does anybody know?

Mr. Brockway?

Mr. Brockway. Well, under the ADR system the life they assign to the midpoint of a refinery would have been 16 years.

The Chairman. The midpoint is the low average, right?

Mr. Brockway. Yes. You could take either 20 percent shorter or 20 percent longer than that life if you decided to take that system. But when they set the midpoint, that was at the 30th percentile of average. So it was shorter than the average. The average in this case would have been something perhaps closer to 20 years. I don't know precisely.

Senator Chafee. And under this legislation, how long do we have it? Under the Chairman's proposal.

Mr. Brockway. Under the Chairman's proposal as modified by the Roth Amendment it would be 10 years double-declining balance.

The Chairman. It is still quite generous.

Senator Chafee. And Senator Boren would like it five years?

Senator Boren. Senator Chafee, I would say it should get the very same treatment as for steel, which I believe also has 16 years. Is that correct?

Mr. Brockway. Steel has a 15.

Senator Boren. And treated as five.

I would just say, again, I think we have to consider also the APA standards, which are continuously changing, which require retrofitting of these refineries. And we simply have to view the capital costs. If we want a decision to be made, if we want a domestic refining industry, we are well on our way to losing it.

As I say, even on this committee, I think my state ranks fourth or fifth down the list in terms of refining capacity; it is not nearly at the top. Even New Jersey, for example, has higher refining capacity than the State of Oklahoma.

So, I am not presenting this from a parochial point of view, but I do think it is very important that we maintain a domestic refining capacity in this country.

The Chairman. Further discussion?

(No response)

The Chairman. If not, do you want a rollcall, David?

Senator Boren. Yes.

The Chairman. Clerk, call the roll.

The Clerk. Mr. Dole?

(No response)

The Clerk. Mr. Roth?

(No response)

The Clerk. Mr. Danforth?

The Chairman. No, by proxy, on Danforth.

The Clerk. Mr. Chafee?

Senator Chafee. No.

The Clerk. Mr. Heinz?

(No response)

The Clerk. Mr. Wallop?

Senator Boren. Both Heinz and Wallop, Aye, by proxy.

The Clerk. Mr. Durenberger?

Senator Boren. Aye, by proxy.

The Clerk. Mr. Armstrong?

(No response)

The Clerk. Mr. Symms?

Senator Symms. Aye.

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. Aye.

The Clerk. Mr. Bentsen?

Senator Bentsen. Aye.

The Clerk. Mr. Matsunaga?

(No response)

The Clerk. Mr. Moynihan?

Senator Moynihan. No.

The Clerk. Mr. Baucus?

Senator Boren. Aye, by proxy.

The Clerk. Mr. Boren?

Senator Boren. Aye.

The Clerk. Mr. Bradley?

(No response)

The Clerk. Mr. Mitchell?

Senator Mitchell. No.

The Clerk. Mr. Pryor?

Senator Pryor. Aye.

The Clerk. Mr. Chairman?

The Chairman. No.

The Clerk. Ten Yeas, five Nays.

The Chairman. The amendment is adopted.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Moynihan, then Senator Chafee.

Senator Moynihan. The amendment will establish a five-year depreciable life?

The Chairman. For oil refineries.

Senator Moynihan. Could I ask Treasury what the real life is for refineries?

Mr. Mentz. Well, as Mr. Brockway just said, Senator Moynihan, it is not clear, but it is in the area of --

The Chairman. Twenty years, he said.

Mr. Mentz. Well, yes, 15 or 20. The ADR midpoint life is 16 years.

Senator Moynihan. Is 16?

Mr. Mentz. Yes.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee?

Senator Chafee. Could I ask what is the cost of that last amendment we adopted?

Mr. Brockway. That is a revenue loss over the period of point-nine compared to the package.

Senator Chafee. Point-nine, meaning -- ?

The Chairman. About a billion. Nine hundred million.

Mr. Brockway. Nine hundred million; that is correct.

Senator Chafee. I think for the sense of the magnitude, rather than just casually referring to things as "point-one or point-seven," let's get the dollars right on the table.

(Laughter)

Senator Chafee. "Point-nine" is not some modest thing short of one.

(Laughter)

Senator Chafee. It is $900 million, am I correct?

Mr. Brockway. That is correct.

Senator Chafee. Mr. Chairman, I just want to report that we are sliding deeper and deeper into the abyss.

The Chairman. We are starting down a long trail.

Senator Long. Mr. Chairman, let me ask a question, since that came up.

Under existing law now, without this bill, is the steel industry and the oil refinery on about the same basis?

Mr. Brockway. They would both receive five years, 150-percent declining balance.

Senator Long. All right, the steel industry and the oil industry receive five years. Is there any change made for steel, or do they still get the five years?

Mr. Brockway. Well, they would get the five years, 200 percent.

Senator Long. Well now, my information, what I am told, is that the depreciable life of the steel industry and the oil refiners is about the same thing. Is that correct, or not?

Mr. Brockway. The ADR system would treat steel at 15 years and oil refineries at 16 years.

Senator Long. All right.

The Chairman. Further amendments in the depreciation section, depreciation, ACRS? Andy other amendments?

Senator Symms. Mr. Chairman, did we vote on my amendment yet?

The Chairman. No, we have not voted on your amendment yet. Do you want to explain it onece more, and we will vote on it?

Senator Symms. Well, Mr. Chairman, many of the senators were here. But basically what it amounts to is that I believe the prudent rule should be that a person shouldn't be liable for the taxes until they receive the money.

If you take the case of a high lift, pumping, sprinkler-irrigated farm operation and the farmer tries to sell his property, half of the value may easily be in pumps and irrigation equipment which he has already depreciated off. When he sells the equipment, the IRS are saying that he is then liable for the entire amount of money of what the contract states.

So let's say, for example, that a farmer sold a million dollar farm, half of which is in irrigation and pump equipment. So, there is a $500,000 income on the books, in the contract of sale, over a 15 year period or a 10 year period to pay off the farm.

The seller then, according to the '84 law, is liable to pay those taxes, and they don't have the money. Most of the time the people who are doing the selling carry the paper or the contract.

All I am saying is that in this case they should be able to not be liable for the taxes until they actually receive the money, which would be $50,000 a year over a 10-year period, for example. Then they pay the taxes on it as they get it, on the recapture.

I think that otherwise these people are just stuck out there. They have a farm they can't afford to seel, because they don't have the cash. And they can't sell the farm, then.

I think it was something that was put into the law in '84, and we should correct it right now.

The Chairman. And what is the cost of this?

Senator Symms. Ten million dollars per year. It would be $50 million over the five-year course of the bill.

The Chairman. And how does Treasury feel on this, Mr. Secretary?

Mr. Mentz. Treasury opposes this. If you would do it for irrigation equipment, I don't see any basis for making a distinction. I think you would have to do it for all other kinds of equipment.

Senator Symms. Well, Mr. Secretary, I am just trying to keep it within the bounds of the bill. But I would just say that, as far as what is right and what is wrong, I don't think any taxpayer should be liable to pay taxes on income that they yet have not received or earned, because these farming operations are so fragile, whether they can pay for them, that half the time they get the farm back anyway. So, what the government is trying to do is to have it both ways: they want you to be liable for the taxes, then if the buyer is unable to fulfill the contract, the seller ends up owning the farm back.

I think there is a logical reason that this just interferes with the ability of people to have an asset that is of any value at all.

Mr. Mentz. Well, Senator, we really don't want it both ways. If the buyer is going to be taking depreciation on a higher purchase price, which he will be doing even though it is an installment sale transaction, the judgment was made by the Congress in '84 that the recapture tax should be paid at the time of the sale by the seller.

All the Treasury is saying is, we don't think you ought to revisit that rule at this time, and certainly not in one specific, limited instance. We think that would be very bad tax policy.

Senator Symms. Well, let me just say one thing before my colleagues would be asked to vote on this.

There are many instances of farming operations in the Columbia Basin that are trying to liquidate their assets so they don't have to go into Chapter Seven bankruptcy, and have found a buyer. And if they are forced to try to pay the tax liability on the front end -- in other words, a front-end load -- and give the government the money up front, they simply cannot make a transaction. So they are stuck with an asset out there that they can't use. They are forced, then, to keep farming, and they are trying to get out of farming because of depressed farm prices, and sell to someone else who is willing to give it a try.

I just think that for us to ignore that -- it is not a big situation, but it certainly is imperative and important for those people who are involved in it. And the prudent rule in fairness and justice would tell you that they shouldn't be expected to pay the tax until they get the money. That is all we are asking for, and we are trying to keep it a very narrow amendment so that these farms can in fact go ahead and sell them and save bankruptcy in many cases.

The Chairman. Further discussion?

(No response)

The Chairman. If not, do you want a rollcall, Steve?

Senator Symms. Well, I just wonder how the committee feels about it. Maybe I don't need a rollcall if they are willing to vote for it.

The Chairman. Well, let's find out. All those in favor of the amendment say Aye.

(Choruse of Ayes)

The Chairman. Opposed, No.

(Chorus of Noes)

The Chairman. The Noes appear to have it.

Mr. Mentz. That's right; you don't need a rollcall.

(Laughter)

Senator Symms. Let's have a rollcall.

The Chairman. Clerk, call the roll.

The Clerk. Mr. Dole?

(No response)

The Clerk. Mr. Roth?

(No response)

The Clerk. Mr. Danforth?

The Chairman. No.

The Clerk. Mr. Chafee?

Senator Chafee. No.

The Clerk. Mr. Heinz?

(No response)

The Clerk. Mr. wallop?

(No response)

The Clerk. Mr. Durenberger?

Senator Symms. Aye, by proxy.

The Clerk. Mr. Armstrong?

(No response)

The Clerk. Mr. Symms?

Senator Symms. Aye.

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. No.

The Clerk. Mr. Bentsen?

(No response)

The Clerk. Mr. Matsunaga?

(No response)

The Clerk. Mr. Moynihan?

(No response)

The Clerk. Mr. Baucus?

(No reponse)

The Clerk. Mr. Boren?

(No response)

The Clerk. Mr. Bradley?

Senator Bradley. No.

The Clerk. Mr. Mitchell?

(No response)

The Clerk. Mr. Pryor?

Senator Pryor. Aye.

The Clerk. Mr. Chairman?

The Chairman. No.

Senator Symms. Mr. Wallop, Aye, by proxy. Mr. Heinz, Aye, by proxy.

The Clerk. Seven Yeas, six Nays.

The Chairman. Senator Baucus?

Senator Baucus. Affirmatively.

The Chairman. Aye. Baucus, Aye. Is that eight-six?

The Clerk. Yes.

The Chairman. Then it passes.

Senator Grassley. Mr. Chairman, could I take up an amendment?

The Chairman. Is this in the depreciation section?

Senator Grassley. No.

Senator Moynihan. Can I vote, Mr. Chairman?

The Chairman. Yes, you may vote. It won't change the outcome.

Senator Moynihan. I vote Yes.

The Chairman. Record Senator Moynihan as No.

Are there other amendments in the depreciation section?

Senator Boren. Mr. Chairman, let me just ask a question: I understand there is some confusion about where fiberoptics fit in under the staff draft. The fiberoptics now have an

ACRS of five years. Of course, it is an area of rapidly changing technology. We have always treated it differently as lines and wires and wood poles, and things like that.

I understand that if it is placed in the "distribution plant" category that it might end up with an ADR midpoint of 35 years, which would be a 15-year depreciable life, which would be a substantial increase.

I would just raise the question at this point, because I am told there might be some confusion the staff is still working on, maybe seeing where it is.

Has there been a resolution of how fiberoptics would be treated, or is that still under discussion with staff?

Mr. Brockway. This is for a telephone company? There appears to be a contention.

The fiberoptics present law is treated as long-term utility property, and we would continue that treatment. It would have 15 years, and it would be productivity property under the proposal for the phone company. So it would be double-declining balance.

Senator Boren. Is that true under deregulated companies? It was my understanding that it is currently five years ACRS. Is that for unregulated sections?

Mr. Brockway. If it is unregulated?

Senator Boren. If it is unregulated.

Mr. Brockway. If it is unregulated, then all equipment is in the five-year class.

Senator Boren. Would that still be true in terms of fiberoptics for unregulated companies under the committee draft? Or would they be moved from five years to 15?

Mr. Brockway. Under the draft, that would not be true; because the draft turns on whether or not it is utility-type property, not whether or not they are regulated in rate of return. So therefore, all of the phone companies, for example, would have the same treatment. It would be 200 percent declining balance over the 15 years.

My understanding, if you are talking about unregulated companies, is that there is some question whether some phone companies that are regulated -- it would be 15 year property right now, and unregulated phone companies would be five years.

This would say that whether or not you are regulated it is the same treatment, and that is the 15-year treatment.

Senator Boren. So that I understand, if you had an unregulated company investing in fiberoptics, they currently have a five-year ACRS, and this would move them to 15 years. Is that correct?

Mr. Brockway. That is correct if you are talking about telecommunications companies.

Senator Boren. Telephone communications.

Mr. Brockway. Other than AT&T, I gather?

Senator Boren. Other than AT&T.

Mr. Brockway. That is correct.

Senator Boren. Which would make that change?

Mr. Brockway. Assuming that under present law they are treated as not being regulated.

Senator Boren. Non-regulated. It would triple the length of their depreciation.

The Chairman. But is the debate here -- AT&T is still regulated?

Mr. Brockway. That is correct.

The Chairman. So they would still be depreciated at 15 years?

Mr. Brockway. That is correct.

The Chairman. So, what we are going to do is give their competitors a tremendous advantage if we give them a five-year depreciation.

Mr. Brockway. That is the way present law works. But basically what the proposal is designed to do is to eliminate any difference.

The Chairman. And treat them equally.

Mr. Brockway. If you provide the same service, you should get the same depreciation.

Senator Boren. I understand, Mr. Chairman, what you are getting at. There may be some other changes that favor regulated companies in terms of certain kinds of economic protections.

Let me just say I would like to delve into this a little further, to see if that is the appropriate place in which we ought to put fiberoptics. I know it is a very rapidly changing technology, and it may be something we should think about.

There was a confusion in my mind as to where it was, and let me just say, to set it aside, that I might want to revisit this or have further discussion with staff about where it ought to be. I know we have to keep fairness within the industry, and perhaps the old regulated/nonregulated distinction is not exactly the way to go, given the current developments in the law.

The Chairman. Further amendments in the depreciation section?

(No response)

The Chairman. Let us move to the accounting section, then.

Senator Bradley. Mr. Chairman?

The Chairman. Senator Bradley?

Senator Bradley. Before we leave the depreciation section, we are actually finished with this now and moving on to the next section? Is that the idea.

The Chairman. Except -- you have suggested -- except for amendments where members have reserved. And you have been very generous, because the person that is interested is not here today.

I have about three or four amendments where members have specifically talked to me and they cannot be here, and they said they want to bring them up. Although I don't think this will be tommorrow, we will get back to it at another time.

Senator Bradley. But I mean on depreciation, not accounting.

The Chairman. We are generally done with depreciation.

Senator Bradley. If I could, I would like to explain why I would like to reserve a right at some point to raise a depreciation.

The Chairman. Go right ahead.

Senator Bradley. Mr. Chairman, the committee has debated the whole issue of cost of capital, and I think that is a legitimate debate to have.

The cost of capital is essentially what it costs to own and purchase a particular asset. For example, if an asset costs a thousand dollars and it wears out over a five-year period, the depreciation cost of the capital is 20 percent. If the company that purchased the equipment borrowed at a 10-percent rate in order to purchase the equipment, that cost of capital goes up to 30 percent.

Now, what the company has to do is earn over 30 percent in order to have any tax component at all to the cost of capital. And in some cases there is a negative cost of capital. To the extent that a depreciation schedule is more generous than economic depreciation, to the extent that an asset lasts 18 years but is depreciated in five years, that constitutes a very generous subsidy, a very generous subsidy that could be used instead to lower the tax rates of individuals in this country.

I would hope, Mr. Chairman, that as the committee deliberates the whole bill, that at some point we might want to come back to the issue of depreciation. And at that time I would hope to be able to offer the committee the choice more directly between less subsidization of particular kinds of assets and lower tax rates for middle and low income people.

The Chairman. Let me tall you what I think is going to happen. You will find in front of you a schedule for the next few days, and then expected order of issues. And down toward the last, above technical corrections and transitional rules and what not, you find the following: "Excise and Employment Taxes, Deductibility of Federal Excise Taxes and Tariffs, Mandatory Refund of Unused ITC Carryovers, Minimum Tax, Individual Rates, Personal Exemptions and Earned Income Credits, and Corporate Tax Rates." Those are all items of billions and billions of dollars. And I have a feeling that when we have disposed of the other items and get to that section or those sections, that we are going to have to sit down among ourselves and say, "All right, folks, which way do you want?"

You make a very, very compelling case for lower rates. You and I have discussed this, and I have stolen some of your ideas and put them in this bill, and I share many of your views. But we are going to have to make a decision at that stage, and I have a feeling we are going to go back over some of the decisions we have made.

But I want to get out of the way, if I can, much of the chaff. Some of it may turn miraculously from chaff to wheat when we go back and look at it again toward the end of this session, but there is no way that we are going now -- with $800 million, $900 million, throw one out here, and throw one out there -- but what we are going to have to revisit some of these decisions, major ones, and also at the end make immense other major decisions.

Senator Bradley. Mr. Chairman, that is precisely what I had envisioned for a proposal that I might offer. If we do get to a point in the deliberations where we want to take a second look at the degree of subsidization that we have provided to particular kinds of assets, I would be prepared at that time to offer what I think would be a more rational depreciation system.

Senator Symms. Mr. Chairman?

The Chairman. Senator Symms?

Senator Symms. On that subject of depreciation, I appreciate what Senator Bradley has just said, but I also think that part of tax reform as it was originally framed was supposed to be simplification and fairness, in addition to rate reduction.

And there are a couple of areas that I would like to bring back up when all of the committee is here on this depreciation question, because I think there are some items that have unfortunately gotten the short shrift from the tax writers -- not by design, necessarily, but it just worked out that way -- in the area of rental property

I would like to bring up an issue or two on depreciation at some point when the whole committee is here.

Senator Bradley. Mr. Chairman, would it be in order to reconsider the irrigation vote?

Senator Symms. It is always in order.

The Chairman. Well --

Senator Bradley. I won't, Mr. Chairman. I was just inquiring.

The Chairman. Let me talk to you afterwards. We are going to get back to revisiting a lot of decisions, and I think there is no point now in going back one at a time and saying shall we reopen this one.

Senator Symms. But what you are saying is that the door will be reopened?

The Chairman. No, it is not going to be reopened for everything. Steve, realistically what we are going to have to do, because I can see this is the way this is going, is we are going to have to make some major philosophical choices about 10 days from now, and they are not just, "Should we reopen it on irrigation?" Or "Should we reopen it on formal wear," or something like that. They are bigger decisions than that.

Further amendments in the depreciation section?

(No response)

The Chairman. Let us go on to accounting, then. Amendments in the accounting section? Any amendments?

Mr. Colvin. Mr. Chairman, on Thursday Senator Mitchell offered an amendment in the accounting area.

The Chairman. Pardon me?

Mr. Colvin. Senator Mitchell had offered one on Thursday.

The Chairman. Oh, yes. That was the $5 million amendment, and I said it was a good amendment. I thought we had adopted it, and I would put it to the committee now. There was no objection to it, to the best of my knowledge, but I would put it to the committee now.

That was an amendment exempting businesses of $5 million and under from -- from what? I am trying to remember.

Mr. Colvin. The uniform capitalization rules applicable to wholesalers and retailers.

The Chairman. Yes. And I thought that was an appropriate size for retailers. Is there an objection to the acceptance of that amendment?

(No response)

The Chairman. Accepted.

Amendments in the accounting section? For the benefit of the members we will go to about 4:00 today.

Senator Chafee. Mr. Chairman?

The Chairman. Senator Chafee?

Senator Chafee. On page 25, installment sales, the so-called builder bonds, what the House provision has done, which the Chairman basically has accepted, if I understand, is as follows: The developer -- and mind you this has nothing to do with low income or middle or medium income housing; indeed, it probably is higher cost housing, if any -- has a massive development, Sunshine City in Arizona, say, and takes back mortgages, which mortgages might be secured by a Ginny Mae or Fannie Mae, or Freddie Mac, or somebody else. And they are to be paid off like any mortgage, in the so-called installment method.

Then he takes these mortgages and refinances them and gets a massive single-sum payment. Is that correct, Mr. Colvin, the way this works?

Mr. Colvin. Yes, Senator Chafee.

Senator Chafee. And then for some reason that counts as an installment obligation and gets treated as an installment sale. Is that right?

Mr. Colvin. That is correct.

Senator Chafee. Well, that doesn't seem to make much sense to me, Mr. Chairman. There is no risk to the borrower in this case; he has been paid. And as I say, in many instances these have been insured, even by private insurers such as the Mortgage Guaranty Insurance Corporation.

So, I don't think these things should be counted as installment obligations. What does the President's proposal do on that, Mr. Mentz?

Mr. Mentz. The President's proposal would basically treat the pledging of any installment obligation as a disposition which would require recognition of income.

When the builder bonds are placed into a trust and are effectively pledged -- that is, borrowed against -- there would be a triggering of income under the President's proposal.

The Chairman. We had a discussion about this the other day and very clearly indicated why we treated them this way. The housing industry lost a source of financing, partially through deregulation of the financial industry; they don't have the support of the savings and loans that they used to --

I am not being critical. But the builder bonds have provided a method of financing homes, and, factually, 75 percent of the mortgages pledged are for bonds for homes of a value of $90,000 or less. These are not Trump Tower investments.

That has become the principal method that large-plot home developers who are building middle-income homes use to finance them.

I think there is a distinction that is justifiably drawn between housing and -- at least we certainly make it true in this committee -- for a variety of other things: low-income housing, mortgage interest deductions. And I think this is a proposal that is a good proposal, and that the draft in the Chairman's proposal ought to be kept.

Senator Chafee. Well, Mr. Chairman, under the amendment that I presented, I say, "For installment obligations secured by real property and guaranteed by a third party other than an individual." So, these are guaranteed. It isn't that he is taking some chance.

Furthermore, I point out that this is not a targeted subsidy. I don't quite know where your statistics came from that they are for $90,000 homes or less; although, in many parts of the countrv other than in Washington the $90,000 is certainly a long way from low-income housing, and possibly would cover average, moderate-income housing.

But the trouble is, this isn't targeted in any way; it makes no difference how expensive the house is going to be. You know, we do target in the mortgage revenue bonds, for example. They are targeted for lower and middle income housing, and this isn't at all.

Mr. Chairman, the Code, as we know, is filled with incentives for single-family housing construction. And there are other methods of access to capital markets because of the growth of the second mortgage market, and builders don't have to issue these bonds.

It is a great thing for the builder, there is no question about it -- "What a deal." He goes and gets his cash, he is all set, and then it counts as installment income. Now, this is a long ways from the way we treat any other installment sale.

In every other installment sale there is an element of risk, whether you are going to get your money. There is no risk here -- he has gotten it. And we are talking here -- originally it was between $2 and 2.5 billion. I think it is somewhat less since I have scaled this back, that restrict it to those obligations that are guaranteed by a third party other than an individual. I don't know exactly what we are talking about in revenue. Do you know, Mr. Brockway?

(Continued on next page)

Mr. Brockway. It is my understanding it would be basically single-family homes. Those are the FHA and VA guaranteed. That would be something in the neighborhood of $1 billion over the period.

All real estate, I think, is $1.9, and this is only applying to single-family residences, and then only those with guarantees. So, it would be roughly $1 billion over the period.

The Chairman. Further discussion?

Senator Chafee. I want to make it clear that it is not just single-family residences, but it is with this guarantee, which would probably come mostly in single-family residences.

Mr. Brockway. That is correct. I think it basically would be single-family residences. There may be some apartments that have Federal guarantees.

Senator Chafee. Again, Mr. Chairman, here is a chance to do two things: one, to get some more revenue toward the target of lowering the rates; and secondly, if we talk fairness, this screams fairness.

And you mentioned previously about wheat and chaff, I think this is something that is wheat for revenue producing and it is chaff for the existing situation.

Senator Bradley. Would the Senator yield just for a question? In the amendment that you are proposing, you would keep builder bonds available for those tracks of homes that are built and insured by third parties?

I mean, what is the number? You dropped from $1.9 to $1 billion.

Senator Chafee. If they were insured by an individual, then my situation wouldn't cover it. But if they are insured by a third party other than an individual--and I am talking about these Federal agencies, or even the Mortgage Guaranty Insurance Corporation--the fellow has got a sure deal.

I mean, if Fannie Mae is going to tumble, he is in tough shape--the whole country is gone.

So, in effect, he has got a secure deal.

Mr. Brockway. I think the items not covered are largely not personal residences. They are largely commercial properties and what have you that the $1.9 billion would have included all real estate, not just these.

And so, limiting to third party guarantees--corporate guarantees--is largely, I think, single-family residences. The $1 billion may be slightly more over the period.

Senator Bradley. So, this amendment would eliminate all of the nonsingle-family financing through builder bonds? A chunk of it, a big chunk of it?

Mr. Brockway. No, just to clarify, the $1.9 was if you applied the rule to all real estate in its entirety.

Currently, the draft does not apply to real estate period. So, this only broadens the draft to pick up these block bonds that are guaranteed. As I say, those are largely single family residences.

So, it would increase by about $1 billion or $1.2 billion from the draft. It doesn't cut back from the draft. The $1.9 billion number I was using for all real estate.

The Chairman. Further discussion?

Senator Mitchell. Yes, Mr. Chairman.

The Chairman. Senator Mitchell?

Senator Mitchell. Mr. Chairman, you have identified this as having the objective of encouraging home building, an objective I think which every member of this committee shares.

I would like to ask a question of any member of the staff or the Treasury. Is there any evidence that has been presented to this committee to support the conclusion that this mechanism in fact does produce more investment in homes as opposed to merely permitting builders who build homes to reduce their tax liability?

That is, has there been any empirical evidence to support the conclusion that continuation of this process will result in, or its existence in the past has resulted in, increased home building?

Ms. Strella. I do have a report from a major organizer of the borrowing through the builder bonds.

The Chairman. I can't hear you.

Ms. Strella. And that report indicates that--and I think the study was conducted over the period of 1982 to early 1985--that these homes were built in 33 States, and they were, as the chairman said, the primary beneficiaries of the homes were they cost $90,000 or less and that the interest rates that were offered to the buyers of the homes were below market by one-half to two percent.

Senator Mitchell. As I gather from what you say, those are the homes, the mortgages on which were used in the builder bond process. The question really is: Is there evidence to suggest that that economic activity would not have occurred but for the builder bonds?

I think that is the crucial question. There is no dispute over the fact that a large number of homes have been built, mortgages have been placed on them, and then the mortgages have been packaged and funds borrowed through the builder bond process.

That is indisputable and, indeed, it is the widespread nature of it that is evidence of its attractiveness to those who have used it.

The question is: Was that study made by those who benefitted from it--as I gather from what you said--but does that or any other study permit the conclusion that the economic activity would not have occurred but for that practice?

Ms. Strella. This study did not address that point.

Senator Mitchell. No. Mr. Mentz, do you have any comment on this provision?

Mr. Mentz. We have no empirical evidence, Senator Mitchell, that this financing practice in fact encourages homebuilding.

Senator Mitchell. Right. And does Treasury support or oppose the continuation of the builder bond process?

Mr. Mentz. Well, I think, as I indicated before, Treasury II, the President's proposal, would have required the recognition of income when the obligations were pledged.

So, that would be consistent with Senator Chafee's amendment.

Senator Mitchell. Right. Thank you, Mr. Mentz.

The Chairman. Further discussion?

Senator Baucus. Mr. Chairman?

The Chairman. Senator Baucus?

Senator Baucus? Mr. Chairman, I am just a little unclear as to why we need builder bonds financing now for the real estate industry.

I think Senator Chafee and Senator Mitchell both raised good points here. There has been some discussion here, and the general thrust of the discussion of the committee has been, with all due respect to my colleague, Senator Mitchell, we are 20 members on this committee and we have choices to make and we have to make some choices we think move in a better direction, compared with a wrong direction, the best we can.

We are elected to make choices, as a matter of fact, the degree to which, as the discussion of this committee has been going, we should move toward the productive assets and the manufacturing equipment and meet the international challenge, etcetera.

Why are we going in the other direction in this bill by encouraging the kind of investment that we are not sure we want to encourage. I think Senator Chafee raises a very, very good point.

His amendment goes somewhat to the nexus and heart of what we are trying to do --

The Chairman. One of the reasons is because we have, throughout almost the history of this country, made an exception for housing for the average American, and we have attempted to encourage it in a variety of ways, both by appropriated funds and the use of the Tax Code.

This is in line with that tradition. We can change. Maybe we want to say this country is overhoused. I don't think so. Maybe we want to say reduce the mortgage interest credit a bit. Don't have builder bonds. Make it a little bit more difficult. Get married and live with your folks for five years.

And instead, tilt that capital toward machines; but that would be a reversal in terms of housing of what at least has been the position of this country and Congress for years and years and years.

Senator Baucus. I understand that, but to some degree, any decision we make in favor of some other area necessarily tends to take away from housing, anyway.

The Chairman. You are absolutely right. And over the years, I have noticed in the dozen years or so I have been on this committee, tax reformers have a variety of philosophies; but one of them is that we are overhoused and that too much of our capital goes for housing; and they would prefer to turn it toward--what do you call it?--productivity equipment or machines.

That is a genuine philosophy they have that this committee and this Congress and Congresses past simply haven't agreed to.

Now, this is a good time to discuss it. Maybe we want to change the philosophy; but that has run through tax reformers, and I don't mean it in the sense of Bradley-Gephardt because even Senator Bradley kept a mortgage interest deduction.

But I mean there are people in that gendre who would eliminate the mortgage interest deduction and who would say: Look at China; look at Japan; look how badly housed they are and how productive they are. We should not be housing people as well as we are, and we should instead be spending the money on machines.

Senator Mitchell. Mr. Chairman, may I just make clear that that is not my position. I don't know who "they" are that you are referring to, but that doesn't include me.

My concern is that there has not been a shred of evidence presented to this committee to support the conclusion that this mechanism will achieve the objective that is stated for it. We have an assertion and we have a conclusion; and there is no evidence whatsoever to suggest that one leads to the other. And that is my objection.

The Chairman. Further discussion?

Senator Chafee. Mr. Chairman, this fellow "they," I haven't met him yet, and I don't know who he is. But he is not me. And to suggest that we think American is overhoused, so therefore, in order to cut down housing, we are sponsoring this amendment, just is not accurate.

And the facts are--and again, going back to what Senator Mitchell said--there is no evidence at all that this produces more houses; but there is perfect evidence that it is a marvelous way for somebody to get the ultimate of tax shelters.

He gets his money; he gets his cash; and then takes it on the installment method over many years. And it just plain isn't fair; and it doesn't produce-- At least, no one --

Maybe Treasury is all wet -- who knows? -- but there is no evidence at all that this helps housing. It makes a lot of builders rich; we know that.

The Chairman. We had a hearing on this. When you say there is no evidence, John, refresh my memory as to what the evidence showed in that hearing.

Mr. Colvin. My recollection of it is the study that Lindy referred to a few minutes ago, with respect to the cost of the housing that was financed by use of builder bonds; and while the study did not indicate whether those houses would have been built without builder bond financing, I believe the viewpoint of the spokesman was essentially empirical, that the transaction had enabled residential construction to occur.

And in connection with putting it in perspective in the accounting area, the chairman's proposal attempted to make provisions that would be even-handed between manufacturing and retailing and between home building.

And the advantages that occur from the use of builder bonds would be greatly lessened under the minimum tax. So, there is an interaction with the minimum tax title that is not immediately before the committee, but should be mentioned.

The Chairman. Further discussion?

(No response)

The Chairman. The clerk will call the roll.

The Clerk. Mr. Dole?

Senator Dole. (No response)

The Clerk. Mr. Roth?

Senator Roth. (No response)

The Clerk. Mr. Danforth?

Senator Danforth. Aye (by proxy)

The Clerk. Mr. Chafee?

Senator Chafee. Aye.

The Clerk. Mr. Heinz?

Senator Heinz. No (by proxy)

The Clerk. Mr. Wallop?

Senator Wallop. No (by proxy)

The Clerk. Mr. Durenberger?

Senator Durenberger. No (by proxy)

The Clerk. Mr. Armstrong?

Senator Armstrong. No (by proxy)

The Clerk. Mr. Symms?

Senator Symms. (No response)

The Clerk. Mr. Grassley?

Senator Grassley. No.

The Clerk. Mr. Long?

Senator Long. No.

The Clerk. Mr. Bentsen?

Senator Bentsen. No (by proxy)

The Clerk. Mr. Matsunaga?

Senator Matsunaga. (No response)

The Clerk. Mr. Moynihan?

Senator Moynihan. Aye.

The Clerk. Mr. Baucus?

Senator Baucus. Aye.

The Clerk. Mr. Boren?

Senator Boren. No.

The Clerk. Mr. Bradley?

Senator Bradley. Aye.

The Clerk. Mr. Mitchell?

Senator Mitchell. (No response)

The Clerk. Mr. Pryor?

Senator Pryor. Aye.

The Clerk. Mr. Chairman?

The Chairman. No.

The Clerk. Seven yeas; ten nays.

Senator Grassley. Mr. Chairman?

The Chairman. The amendment is defeated.

Senator Grassley?

Senator Grassley. Mr. Chairman, I want to offer an amendment, and this amendment would delete that portion of your proposal, Mr. Chairman, requiring the capitalization of accelerated portion of depreciation deductions on plant and equipment used in producing inventory.

The Chairman. How much does it cost?

Senator Grassley. $5 billion.

The Chairman. $5 billion?

Senator Grassley. For five years.

Senator Chafee. Oh, come on, I think it sounds good.

Senator Grassley. Have we not had figures that high yet?

(Laughter)

Senator Bradley. Is that in one year or five years?

Senator Grassley. That is five years.

Senator Bradley. Five years? Okay.

Senator Grassley. Now, current law requires that depreciation deductions be taken for -- purposes to be capitalized as the cost of inventory.

And of course, my amendment would postpone the deduction for that cost-- Or I mean, the chairman's proposal postpones the deduction for that cost until the inventory is sold.

The chairman's proposal would require the capitalization in inventory of all depreciation taken for tax purposes including the accelerated portion.

Now, of course, my amendment would retain current law, and I would like to give the rationale for my amendment. Now, I would like to refer to the debate just last Thursday, I believe it was, when we debated incentive depreciation for plant and equipment used in productive activities.

Now, I would like to suggest to the committee that this decision we made just last week, that we are compromising that to a considerable extent by deferring the difference between the tax or accelerated depreciation by capitalizing that amount.

It is going to dilute the intent of the incentive effect that we had on our amendment last week, or that was argued for the Roth amendment.

Also, the remaining incentive will be distorted among different industries, based on varying inventory turnover rates; so I suggest an unfairness in the chairman's approach as industries with high turnover rates would be virtually unaffected while those with low turnover rates--and I would use steel as an example--would have virtually no incentive depreciation.

Also, I would like to refer to the usual cost of goods sold deduction which is in part determined by inventory rules. It will be divorced from its goal of identifying real economic income, the extent to which you want real economic income to be the basis for our tax--or at least the philosophy in our tax--law.

The accelerated portion is an incentive and not a real economic cost of producing inventory. So, we depart from --as far as I can see in the chairman's proposal--an economic purpose being the justification for paying tax.

And so, I offer this amendment. I know it is costly, but I think I also ought to refer back to the fact that, if you remember originally what the House did in their bill, they proposed some of the chairman's rationale for inventories be applied to manufacturing.

And of course, the chairman then extends it to retailing and wholesaling. And let me suggest that overall my amendment would be saying that, whereas the chairman's right that we ought to apply it maybe for retailing and wholesaling if we do for manufacturing.

My amendment is basically saying that this wrong for both manufacturing as well as retailing and wholesaling.

The Chairman. Discussion? Mr. Secretary?

Mr. Mentz. Mr. Chairman, Treasury would oppose Senator Grassley's amendment. Basically, the accelerated portion of depreciation is one of the costs that is incurred in the production of inventory and, under the various systems of inventory taxation that are present in the U.S. Tax Code, those expenses are recovered when the property is sold.

In other words, if you are to capitalize accelerated depreciation, it doesn't mean that you don't get the accelerated benefit; it simply means that the deduction is matched with the income so that when the inventory item is sold, the full amount of the cost of sales is effectively deducted; and that is how your profit is computed.

Now, the Congress faced the same issue in 1982 in TEFRA when the capitalization rules for extended period long-term contracts were debated, and the same result as in the chairman's proposal was accepted there. And that is that the full amount of the tax depreciation is capitalized and then taken as an offset to profit when the inventory is sold.

That is really a very normal ordinary kind of an accounting procedure, and frankly, we don't see anything wrong about it or anything that weakens or dilutes an incentive. The incentive is there. It is simply available when the inventory is sold.

So, I would say another strong argument is $5 billion. I would very strongly suggest that the amendment not be supported.

Senator Grassley. Mr. Chairman, could I direct a question to the Secretary? You referred to 1982 accurately in the sense that we did deal with the general subject matter at that point; but that legislation at that time was for long-term Government contracts.

It was never meant to be applicable to short-term situations like we are now dealing with, and particularly not meant to deal with inventories for retail and wholesale.

Also, you know, the issue of whether or not it ought to be done in the first place for manufacturing, I think, is questionable in the sense that we have traditionally capitalized long-term straight-line depreciation; but we have not done it with the acceleration portion of the depreciation. And whether or not in a time when we are using the Tax Code to encourage productivity, if we ought to depart from it in this instance, then this is what we are doing.

Senator Symms. Excuse me. Would the Senator yield for a question?

Mr. Mentz. I think that was a question, wasn't it?

Senator Grassley. Yes.

Mr. Mentz. You were referring to TEFRA and saying that that is only extended to long-term contracts.

Senator Grassley. Well, I wish you would at least agree with me that it was intended for long-term Government contracts.

Mr. Mentz. I do agree with you, Senator. Absolutely.

Senator Grassley. Okay. But you are using that as an argument.

Mr. Mentz. I am using that as an example of a situation where, when a capitalization rule was extended, the full amount of the depreciation was picked up, not just a straight line amount.

And I am only using that by analogy; I am not arguing --and I certainly agree with you--that TEFRA did not extend the full capitalization rules to inventory. That is what we are trying to do here now. That is what the chairman's proposal is.

Senator Grassley. My question is, basically, Mr.

Secretary: Do you think that in the case where we did it for long-term Government contracts, that that is an entirely different situation than what we are trying to do here?

That is what I am trying to say, and it is quite obvious that I think you disagree with that; but you are saying that they are comparable situations and that the same law ought to apply?

Mr. Mentz. I am saying that the concept that was introduced in TEFRA is being extended. It is proposed that it be extended, and the extension is simply a better measurement and a more accurate measurement of taxable income.

And that is what the chairman's proposal does, and it still provides the incentive, but the depreciation incentive comes when the inventory is sold. Senator Symms?

Senator Symms. Mr. Chairman, I want to ask another question on that, but let's get back to this point of simplification of the Tax Code.

The President made some comment last week where he was still wanting to simplify the Income Tax Code, as he filed his income taxes.

Let's place this on the small businessman, Main Street, U.S.A. in a small town. How does this impact a retail, say, a clothing store?

Let me first ask a question. Isn't it true that if you hire somebody to work in the clothing store, that normally you would be able to deduct off the wages and salary that you pay that person?

Mr. Mentz. Yes, and I don't think the chairman's proposal changes that. If I understand our amendment that was adopted, we have a $5 million floor. Is that right? So, the typical small retailer would be exempt.

I think a better example, Senator Symms, would be a small manufacturer.

Senator Symms. Okay. Explain to me, give me a specific example of how this would work in the chairman's proposal and how current law works.

Mr. Mentz. For a manufacturer--it doesn't matter what size--under current law, depreciation of the equipment that is being used to manufacture the Widgets that he is selling is currently deducted.

Under this proposal, the depreciation--the tax depreciation--would be in effect allocated to the inventory produced and then, in effect, deducted when the inventory is sold.

It is purely a timing matter; so if you sold all your inventory in the same year you produced it, there would be no difference. The results would be exactly the same.

But because most businesses have an inventory at year's end that usually isn't sold until the next year, there is this inventory difference. And in that case, the portion of the inventory that isn't sold would have in it capitalized these costs that would effectively not be deducted until that inventory is sold.

Senator Symms. Then, you would have to capitalize the cost of the depreciation factor in the manufacturing of the Widget?

Mr. Mentz. That is right, which is a fairly straight forward accounting matter. I don't think it --

Senator Symms. It isn't as simple as the current law, though?

Mr. Mentz. Yes, it really is. It is just a question of the bookkeeper coming in and what he does with the depreciation. It is really a fairly straight-forward accounting or bookkeeping --

Senator Symms. Let's say that your cost to produce it is $1,000. Then you have to estimate what the depreciation is in the plant.

Mr. Mentz. You wouldn't have to estimate it; you would know it.

Senator Symms. All right. Then, you would add that on --

Mr. Mentz. You would effectively add that on, and if that particular item of inventory were not sold in the current year, but rather in the next year--let's assume you are on a FIFO inventory system--effectively, that piece of the depreciation wouldn't be deducted in year one; it would be deducted in year two when the inventory is sold.

But for all the pieces of inventory that were manufactured and sold in year one, you would get the full deduction for the depreciation.

Senator Symms. I doubt if you could convince the manufacturer that that is more simple than the current law.

Mr. Mentz. I guess I am just saying it is not more complicated. I am not saying it is more simple. I think it is about the same.

Senator Symms. But it gets money into the Treasury on the front end. What about at the last year?

Mr. Mentz. Well, this is one of those items that --

Senator Symms. In other words, this will make that manufacturer pay more taxes the first year. How about the last year?

Senator Grassley. Oh, Mr. Secretary, the whole thing is a one-time revenue raiser, and I think we are letting the amount of revenue coming in one time obscure how very complex this whole approach is going to be.

Mr. Mentz. We have tried to analyze this. The question has come up before about are we talking about one time, or: How much revenue is there going to be beyond the budget period on these kinds of accounting adjustments?

And I think that is a very important question. On this item, our revenue estimate is--or our estimate, it is not a revenue estimate--is that 20 percent of the revenue will be steady-state revenue beyond the budget period.

In other words, after this rule is fully phased in, you will still have--and it is because of an increase in inventories and an increase in business--a 20 percent revenue increase, year by year, after the five-year budget period.

Senator Symms. The question I am getting back to is: Why wouldn't it be simpler just to take these small people that are going to be affected by this, or these people big or small, and just make an interest-free loan to the Government the first year and not have the Government pay them interest--just make them pay the taxes early.

I just can't see what the integrity to the accounting is to get this one-time, up-front revenue. I mean, what this proposal is saying is that we are going to go out here and rake this money into Treasury the first year so all those people that have to pay it, what they do is give the Treasury an interest-free loan for a year.

And at the end of five years, if it is the same amount of money to Treasury, I don't see how we come up with the accounting that the Grassley amendment cost $5 billion.

Mr. Mentz. I think it is a matter of accounting integrity or measuring taxable income with integrity. That certainly is the intention here, and the concept is that you try to allocate costs to items of inventory and, when the income is recognized--when the inventory is sold--that is when you get the costs of the deduction, including the depreciation.

That is the theory behind it, Senator Symms, and I really don't honestly think that, for a manufacturer that already has to maintain depreciation schedules, it is really going to be any different in terms of complexity whether you capitalize it or whether you don't.

Senator Symms. Could I ask a little broader question? In the entire question of the accountability, the Grassley amendment is one part of it; but isn't it true that there is about $55 billion approximately in this proposal?

Mr. Mentz. In the whole accounting section.

Senator Symms. In the whole accounting section?

Mr. Mentz. That is right.

Senator Symms. Is there really any difference in what I am suggesting, that you just force all these businesses to loan the Government the money interest-free? Loan the Government $50 billion interest-free? Wouldn't that do the same thing? And leave the Tax Code alone. Maybe it would be easier on the businesses.

Mr. Mentz. I guess I don't exactly share your view.

Senator Symms. Where are you going to be at the end? That is what I am trying to find out. We are saying here that the Grassley amendment costs $5 billion, but the whole section is $55 billion.

And you could look at each one of these accounting changes, all change the accounting procedures where the Government gets the money the year earlier. Isn't that correct?

Mr. Mentz. There is a steady-state, a long-term revenue enhancement of this provision, and that is because it is a better match of the depreciation deduction with the income. Now, what the President tried to do, what Treasury I tried to do, what Bradley-Gephardt tried to do--just about all of the fundamental tax reform plans, including the chairman's--is to try to more accurately measure income, taxable income.

That is what the whole accounting changes are all about. I think it is really not giving them a fair treatment to say, well, why don't you just make it an interest-free loan?

I think there is more to it than that. I think there is more integrity to it than that. Perhaps my explanation isn't getting through here.

Senator Symms. What will happen the sixth year then?

Mr. Mentz. In the sixth year, and all years further out, there still is going to be a revenue benefit from this provision as opposed to current law, and that is because some inventory is going to be produced in that year but not sold; and with respect to that inventory, the depreciation is capitalized.

Senator Symms. Let me ask you one other question, if I could, Mr. Chairman? If we believe that it costs so much money to provide a job in the private sector, and I think Treasury has numbers on that--how much do you estimate that it costs to provide a job in the private sector, say in manufacturing?

Mr. Mentz. I don't know, Senator.

Senator Symms. $20,000? $40,000? Mr. Chairman, if I could just pursue this a little further?

If we believe that, that it takes $15,000, $20,000, $40,000 to provide a job in the private sector, and we are going to take this money away from these manufacturers on the first year, how many jobs is that going to cost us, and how much revenue will be lost to Treasury on the years through less people working?

Mr. Mentz. Bear in mind that we are attempting to do a revenue neutral tax reform that results in lower rates and, effectively by providing those lower rates and by providing the more neutral depreciation system, you are going to have a more efficient system and one that works better.

I think that is certainly where the chairman was coming from.

The Chairman. This is one of those subjects that I think every committee member has been over and over, and has been lobbyed and lobbyed on; and before we adjourn, and we have a large turnout here, I would like to put the vote today if I could.

We can laugh and kid about what we have done so far. This is $5 billion, and I think if this one passes, we just have opened the spillway--we have broken the dam.

I would like to ask the clerk to call the roll.

The Clerk. Mr. Dole?

Senator Dole. (No response)

The Clerk. Mr. Roth?

Senator Roth. (No response)

The Clerk. Mr. Danforth?

Senator Danforth. (No response)

The Clerk. Mr. Chafee?

Senator Chafee. No.

The Clerk. Mr. Heinz?

Senator Heinz. Aye (by proxy)

The Clerk. Mr. Wallop?

Senator Wallop. Aye (by proxy)

The Clerk. Mr. Durenberger?

Senator Durenberger. (No response)

The Clerk. Mr. Armstrong?

Senator Armstrong. Aye (by proxy)

The Clerk. Mr. Symms?

Senator Symms. Aye.

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. No.

The Clerk. Mr. Bentsen?

Senator Bentsen. No (by proxy)

The Clerk. Mr. Matsunaga?

Senator Matsunaga. No (by proxy)

The Clerk. Mr. Moynihan?

Senator Moynihan. No.

The Clerk. Mr. Baucus?

Senator Baucus. No.

The Clerk. Mr. Boren?

Senator Boren. Aye.

The Clerk. Mr. Bradley?

Senator Bradley. No.

The Clerk. Mr. Mitchell?

Senator Mitchell. No.

The Clerk. Mr. Pryor?

Senator Pryor. No.

The Clerk. Mr. Chairman?

The Chairman. No.

The Clerk. Six yeas; ten nays.

The Chairman. The amendment is defeated.

Senator Grassley. Mr. Chairman?

The Chairman. Senator Grassley?

Senator Grassley. What I would like to do now is try and amendment that will cost $1.9 billion; and this deals with the same subject matter, but it would not require the capitalization of accelerated portion of the depreciation deduction for assets placed in service or for which a binding contract has been signed prior to the ITC repeal date.

So, I don't think there is any sense in going into a debate of the rationale. The rationale would be the same, but we would apply the principle just to those that have been already in service, where there has been a legitimate decision made prior to the change in the law.

The Chairman. Does Treasury have an opinion?

Mr. Mentz. We sure do, Mr. Chairman. We would oppose this one as well; and the reasons are basically similar to the points that Senators Grassley and Symms and I were just discussing.

But there is one other argument here that I think bears thinking about. In the case of an asset that has been placed in service before the effective date or before tax reform --let's say you have a five-year asset and it has been in service for three years--that asset under ACRS is receiving very favorable tax treatment.

You are getting front-end deductions, and those deductions are at 46 percent. That is because that is the way presently

ACRS works. Now, when the accelerated depreciation ends after two more years, the income from that asset is going to be taxed at a lower rate.

It is going to be taxed at 35 percent under the chairman's proposal. So, there is an inherent benefit already by reason of the drop in rates.

The Chairman. It gives those assets now in place a competitive advantage over the ones we put in place tomorrow or next week.

Mr. Mentz. Absolutely right.

The Chairman. Further discussion?

(No response)

The Chairman. The clerk will call the roll.

The Clerk. Mr. Dole?

Senator Dole. Aye (by proxy)

The Clerk. Mr. Roth?

Senator Roth. (No response)

The Clerk. Mr. Danforth?

Senator Danforth. (No response)

The Clerk. Mr. Chafee?

Senator Chafee. No.

The Clerk. Mr. Heinz?

Senator Heinz. Aye.

The Clerk. Mr. Wallop?

Senator Wallop. Aye (by proxy)

The Clerk. Mr. Durenberger?

Senator Durenberger. (No response)

The Clerk. Mr. Armstrong?

Senator Armstrong. Aye (by proxy)

The Clerk. Mr. Symms?

Senator Symms. Aye.

The Clerk. Mr. Grassley?

Senator Grassley. Aye.

The Clerk. Mr. Long?

Senator Long. No.

The Clerk. Mr. Bentsen?

Senator Bentsen. (No response)

The Clerk. Mr. Matsunaga?

Senator Matsunaga. Aye.

The Clerk. Mr. Moynihan?

Senator Moynihan. No.

The Clerk. Mr. Baucus?

Senator Baucus. No.

The Clerk. Mr. Boren?

Senator Boren. Aye.

The Clerk. Mr. Bradley?

Senator Bradley. No.

The Clerk. Mr. Mitchell?

Senator Mitchell. No.

The Clerk. Mr. Pryor?

Senator Pryor. Aye.

The Clerk. Mr. Chairman?

The Chairman. No.

The Clerk. Nine yeas; seven nays.

The Chairman. The amendment is adopted. I think it is 4:00, and I indicated to the members we would quit about this time; so we will recess until tomorrow morning.

Senator Chafee. Mr. Chairman, I just want to say on these wholesale or retail capitalization matters that I have some reservations that haven't really been met by the Grassley amendments.

I think he has some other amendments; I don't know. And I think Senator Durenberger had some proposals. Am I correct in that? Does he have an amendment in this area?

Mr. Colvin. Yes, sir.

Senator Chafee. So, we will be voting further on those matters, I presume, in the morning?

The Chairman. No, I am going to put off some of these. In the morning, I want to go through our discussions on a couple of items.

We will put this in when we can, but I am not going to start on it in the morning.

Senator Chafee. Let me just say, Mr. Chairman, that I have some definite problems with these wholesaler and retailer capitalization rules, and Senator Durenberger's amendment, I believe, is the one I will be supporting, but I will be back to it, and I just wanted to serve notice that although I didn't vote for Senator Grassley's amendment, I have some real concerns about these matters.

The Chairman. Adjourned until 9:30.

(Whereupon, at 4:02 p.m., the meeting was recessed, to reconvene at 9:30 a.m. on Tuesday, April 15, 1986.)

CERTIFICATE

This is to certify that the foregoing proceedings of an Executive Committee meeting of the Committee on Finance, held on Monday, April 14, 1986, in re: Tax Reform, were held as herein appears and that this is the original transcript thereof.

William J. Moffitt

WILLIAM J. MOFFITT
Official Court Reporter

My Commission expires April 14, 1989.

United States Senate

COMMITTEE ON FINANCE
WASHINGTON, DC 20510

Press Release No. 86-030

PRESS RELEASE

FOR IMMEDIATE RELEASE
Monday, April 14, 1986

Contact: Betty Scott-Boom
(202) 224-4515

FINANCE COMMITTEE ACTION ON TAX REFORM PROPOSAL

Chairman of the Committee on Finance, Bob Packwood (R-Oregon) announced that the Committee took action on the employee benefits provisions (Title XIV-F), the accelerated cost recovery system provisions (Title II), and the accounting provisions (Title III) of the Chairman's tax reform proposal. The following modifications to the Chairman's proposal were agreed to:

1. Awards of tangible personal property made by an employer to an employee in a year for length of service or safety achievement would be excludable from income, subject to certain limitations, for up to $400 of cost ($1,600 if made under a qualified plan where the average cost does not exceed $400). As under the Chairman's proposal, all other employee awards (e.g., for productivity) would be includable in income.

2. Assets used in petroleum refining would be moved to five years, 200 percent declining balance, from 10 years, 200 percent declining balance.

3. Wholesalers and retailers with gross receipts of $5 million or less would be exempt from the uniform capitalization rules.

4. Under a transitional rule, the present-law treatment of the accelerated portion of the depreciation deduction (the excess of tax depreciation over depreciation claimed for financial purposes) would be retained for plant and equipment used to produce inventory or self-constructed assets, provided the plant or equipment was placed in service prior to March 1, 1986, or the taxpayer had a binding contract to purchase the plant or equipment on that date.

5. Depreciation recapture income realized on installment sales of farm irrigation equipment would be taxable under the rules applicable prior to the Deficit Reduction Act of 1984. Thus, recapture income would be recognized as payments are made, rather than in the year of sale.

P.R. #86-030

SEN. CHAFEE "TREASURY" AMENDMENT

4/15/86

Amended Treasury Transition Rule Proposal for Withholding

Taxes on Cross-Border Loans

Modify the Chairman's proposed transitional rule as follows:

1. Grandfather all loans to residents of countries not subject to the Baker Initiative outstanding on November 16, 1985 for a period of 10 years beginning with the effective date of the new rule (January 1, 1986 in the House bill; January 1, 1987 in the Senate spreadsheet).

2. With respect to loans to residents of the 15 countries subject to the Baker Initiative only, permit loans to be rolled over, rescheduled, restructured, or otherwise rearranged among borrowers resident in the 15 countries on a lender-by-lender basis so long as the total amount of foreign taxes creditable on an annual basis with respect to such loans held by a given lender does not exceed the dollar amount creditable with respect to loans held by such lender on November 16, 1985. (N.B. this limit is based on credits available with respect to existing loans, not the principal amounts of such loans.)

3. Increase the dollar amount of the overall lender-by-lender limitation in Paragraph 2 above by 3 percent per annum for a period of three years beginning with the effective date of the new rule. Adjust this limitation to take into account movements in market interest rates (i.e. if rates increase, the limitation will increase and vice versa).

4. Thereafter, subject loans to the Baker Initiative countries to the same rule applicable to other loans from day one (i.e. grandfather interest paid on continuing loans but treat any rollover, restructuring, or rescheduling after the three year period as a new loan subject to the new separate basket limitation to the extent such a change would be treated as a new loan under current law). Provide permanent grandfather treatment for existing Baker Initiative loans and for new or restructured loans to residents of the Baker Initiative countries entered into during the three year transition period.

5. Provide a special per country "floor" to limit the benefits derived from any excess grandfathered credit generated by sale or transfer (but not repayment) of existing loans to residents of the Baker Initiative countries (i.e., a lender will not be able to derive benefits from credits relating to loans outstanding on November 16, 1985 to residents of one Baker Initiative country if such loans are sold and replaced by loans to a second Baker Initiative country).

Under the proposed transitional rule a lender to the 15 countries can do whatever it likes with respect to existing loans, including increasing the principal amounts of such loans and switching loans among residents of the 15 countries (subject to paragraph 5 above) so long as the lender does not exceed the credit limitations described in paragraphs 2, 3, and 4 above. In effect, lenders to the 15 countries will be given 3 years from the effective date to rearrange their affairs in that group of countries before the separate basket rule will apply to new loans. Note that this rule should give the 15 countries an incentive to reduce their withholding rates during the transition period in order to attract new loans (e.g. everything else being equal, if a country with high withholding taxes cuts its withholding rate by one half, existing lenders will be able to double the principal balances of their outstanding loans without running afoul of the limitations described above).

Baker Initiative Countries

Argentina
Brazil
Chile
Mexico
Nigeria
Philippines
Venezuela
Bolivia
Colombia
Ecuador
Ivory Coast
Peru
Uruguay
Yugoslavia
Morocco

4/15

CHAFEE AMENDMENT TO THE GRANTOR TRUST PROVISIONS

The trust's taxable income will be taxed according to the following rate schedule:

If taxable income is:	The tax is:
Not over $8,500	15% of the taxable income
Over $8,500 but not over $24,225	$1,275 plus 25% of the excess over $8,500
Over $24,225	$5,206.25 plus 35% of the excess over $24,225

4/15/86

CHAFEE AMENDMENT ON CERTAIN DISCLAIMERS

With respect to an interest in property created by a gift, devise or bequest made before November 15, 1958, a disclaimer by a person of such interest (in whole or in part) shall not be treated as a transfer for purposes of chapters 11 and 12 of subtitle B of the Internal Revenue Code of 1954 if such disclaimer satisfied the requirements set forth in Treasury Regulation Section 25.2511-1(c) as in effect at the time the disclaimer was made. For this purpose, the requirement of such Regulation that the disclaimer be made "within a reasonable time after knowledge of the existence of the transfer" shall be satisfied if such disclaimer was made in writing before February 22, 1982 and no later than a reasonable time after termination of all interests in such property prior to the disclaimed interest.

SEN. GRASSLEY
4/15

SPECIAL USE VALUATION AMENDMENT

Section 2032A of the Internal Revenue Code would be amended to terminate the recapture period for specially valued property after 10 years (rather than 15 years) in the case of estates of decedents dying before 1982.

SENATE COMMITTEE ON FINANCE
TAX-EXEMPT BONDS
April 15, 1986

OPENING STATMENT OF SENATOR DAVE DURENBERGER

Mr. Chairman, the modifications of the tax-exempt bond provisions that you and I have agreed to represent a major step in improving the ability of State and local governments to provide basic and vital services to their communities. I appreciate the fact that you have accomodated many of the principles embodied in my tax-exempt bond legislation, S. 2166, within the revenue constraints of this tax reform bill.

I would just like to note some of the important improvements that we have achieved through this agreement. Of utmost significance, we have agreed to maintain the 25% "use" and "security interest tests" in current law that will enable State and local governments greater flexibility in providing necessary services. The 25% tests, coupled with liberalized management contract rules, will allow local governments to move further in working with the private sector to deliver community services.

Our agreement further provides that bonds issued for multifamily housing projects will not be included in a State volume cap. At a time when the Federal government has significantly diminished its role in helping State and local governments build housing for lower income members of the community, I believe it is vitally important that State and local governments be allowed to expand the nation's housing stock for those who need decent affordable shelter. This agreement gives substance to our commitment to these vitally needed projects.

We have taken steps to safeguard the right of state and local governments to finance needed infrastructure for water, sewer and solid waste. Publically owned facilities will not be subject to any restrictive state volume cap. And, those facilities that are privately owned will continue to enjoy improved depreciation.

The growing problem of hazardous waste disposal is also addressed in our agreement. Governmentally owned facilities are not restricted by the State volume cap and facilities while private operators of hazardous waste facilities that are covered under the volume cap will be able to take advantage of the benefits of accelerated depreciation.

In addition, of critical importance to our nation's future and our international competitiveness, in particular, is our ability as a society to provide the best educational opportunities for today's students. At a time when the cost of college is, in many instances, greater than $16,000 a year, many middle income families find it nearly impossible to fund their children's academic future. Our agreement not only provides for the continuation of tax-exempt financing for the Federally Guaranteed Student Loan Program, but also allows tax-exempt financing for State Supplemental loan programs.

Mr. Chairman, the issue of true abuses of tax exempt financing is an important one. We have also reached a workable agreement that addresses how, if at all, State and local governments that violate the restrictions on arbitrage will be penalized. We have agreed that the Treasury must notify State and local issuers of these bonds when it appears they have violated arbitrage restrictions. Issuers will then be given a 6 month period to cure any defects in their investments and, if the defect is not cured, they will have to rebate aribitrage profits to the Federal government. Failure to rebate will result in a penalty imposed on the issuer. However, the Secretary of the Treasury will have discretion to waive this penalty.

SEN. DURENBURGER
4/14

POSSIBLE MODIFICATION TO THE TAX-EXEMPT BOND PROVISIONS

Adopt the Chairman's proposal with the following modifications:

1. Increase the 10% use and security interest test to 25%.

2. Place multifamily housing bonds outside the IDB volume cap.

3. Student loan bonds are expanded to include supplemental loans.

4. Rebate penalties will be modified to provide as follows: A penalty will be imposed on the issuer of bonds if he fails to rebate. He has six months in which to cure this defect (with interest). After a six-month period he will pay a 100% penalty. If he fails to cure defects and pay the penalty, then the bonds become taxable.

5. The following are added to the category of tax-exempt IDB's subject to a volume cap:

   a. District heating and cooling facilities

   b. Hazardous waste facilities.

6. Clarify that the "safe harbor rules" for purposes of airports, docks and wharves electing outside the volume cap is as follows: "leases not more than 80% of the facility's useful life with no option in the lease to buy the facility at less than fair market value."

7. Require that the Treasury SLGS program, as modified by the Chairman's proposal, be in place as of January 1, 1987.

8. As under current law, each state's volume limitation is allocated one-half to State issuers and one-half to local governments within the state on the basis of relative populations unless the state adopts a statute providing a different allocation. Clarify that the Governor of each State is permitted to issue a proclamation overriding the Federal rules prior to State legislation allocating the volume limitation.

9. Minimum size requirement for designated blighted area would be reduced from 15 to 10 contiguous acres.

All other provisions in the Chairman's proposal are adopted without change. Those provisions include:

1. the present law volume cap, and

2. the arbitrage rules and advance refunding.

(TED-0233)

TREASURY
4/14 A.M.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

April 14, 1986

The Honorable Bob Packwood
Room 259
Russell Senate Office Building
First and Constitution, N.E.
Washington, D. C. 20510

Dear Bob:

I have reviewed the Department of the Treasury's suggested modifications in the transition rule that you have proposed as part of the limitations on the availability of foreign tax credits for withholding taxes on the interest income that financial institutions receive from cross border loans.

I agree with the Treasury that a less abrupt transition rule for bank loans to developing countries would be more consistent with the ongoing international cooperative efforts to deal with the complex external financing problems of those countries. We support the Treasury's proposal to give banks with loans outstanding to certain debtor countries more flexibility to restructure those loans and to broaden the transition period. We may have further technical comments as the Senate Finance Committee continues its deliberations on the tax bill.

Sincerely,

Paul A. Volcker

cc: The Honorable Russell B. Long
The Honorable James A. Baker III

SENATE FINANCE COMMITTEE
4/14 A.M.

This is the Key!
The larger the foreign source income, the larger the credit.

April 10, 1986

$$(\text{U.S. tax X worldwide income}) \times \frac{\text{Foreign source income}}{\text{Worldwide income}} = \text{The F.T.C.*}$$

Example 1: Assumption -- a. Foreign source income = $1,000

b. U.S. income = $2,000

c. Therefore, worldwide income is $3,000

d. A U.S. tax rate of 30%

$$(30\% \times \$3{,}000) \times \frac{\$1{,}000}{\$3{,}000} = \$300 \text{ (Foreign Tax Credit)}$$

Example 2: Assumption -- a. Foreign source income = $1,500

b. U.S. income = $1,500

c. Therefore, worldwide income is $3,000

d. A U.S. tax rate of 30%

$$(30\% \times \$3{,}000) \times \frac{\$1{,}500}{\$3{,}000} = \$450 \text{ (Foreign Tax Credit)}$$

* This is the highest amount of foreign tax which can be claimed as a credit. Of course, taxpayers cannot claim credits greater than the taxes actually paid.

The U.S. taxpayers want to have the largest foreign tax credit they can. They do this by increasing foreign source income.

The foreign source income is increased by:

1. Sourcing income abroad
2. Allowing averaging of all foreign income.
3. Allocating expenses to the U.S.

The foreign source income is decreased by:

1. Sourcing income in U.S.
2. Putting foreign income in separate baskets.
3. Allocating expenses abroad.

CORRECTED
414
SEN. CHAFEE

CHAFEE INSTALLMENT SALES AMENDMENT

FOR INSTALLMENT OBLIGATIONS SECURED BY REAL PROPERTY AND GUARANTEED BY A THIRD PARTY OTHER THAN AN INDIVIDUAL, IF THE INSTALLMENT OBLIGATION IS PLEDGED (DIRECTLY OR CONSTRUCTIVELY) FOR A LOAN, THE PROCEEDS OF THE LOAN GENERALLY WOULD BE TREATED AS PAYMENT ON THE OBLIGATION, AND PROPORTIONATE AMOUNTS OF DEFERRED GAIN WOULD BE RECOGNIZED.

INSTALLMENT OBLIGATIONS WILL BE TREATED AS DIRECTLY PLEDGED WHEN THEY ARE EXPLICITLY DESCRIBED AS SECURITY FOR DEBT. OBLIGATIONS WILL BE TREATED AS CONSTRUCTIVELY PLEDGED WHEN THEY ARE TRANSFERRED TO A FINANCING CORPORATION, WHEN THEY REPRESENT 50% OR MORE OF THAT CORPORATION'S ASSETS, AND WHEN EITHER STOCK OF SUCH CORPORATION IS PLEDGED AS SECURITY OR SUCH CORPORATION BORROWS ON AN UNSECURED BASIS.

IF DIRECTLY PLEDGED INSTALLMENT OBLIGATIONS ARE NOT THE SOLE SECURITY FOR DEBT, THEN THE AMOUNT OF NET LOAN PROCEEDS WHICH ARE TREATED AS CURRENT INCOME WILL BE IN PROPORTION TO THE RATIO OF THE PLEDGED OBLIGATIONS OVER THE TOTAL SECURITY.

THE NEW RULE WILL APPLY TO OBLIGATIONS WHICH ARE PLEDGED IN THE TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986.

SEN. CHAFEE
4114

April 14, 1986

EMPLOYEE ACHIEVEMENT AWARDS -- COMPROMISE PROPOSAL

Elimination of Productivity Awards and Prevention of Tax Abuse

Problem: The "Chairman's Proposal" described in the March 18 Joint Committee Print of the Tax Reform Proposal (Art. XIV, Sec. 4, p. 165) would repeal the exemption for employee awards and tax all awards that have more than nominal value. Even the special deduction rules for such awards would be repealed. This position should be reconsidered to preserve the long-standing exemption for length of service and safety achievement awards while dropping productivity awards and eliminating the possibility for tax abuse.

Proposal: The present law provisions for employee awards would be changed in the following ways:

a. Employee Awards for "productivity" would be eliminated entirely.

b. Deductible awards for length of service and safety achievement (without distinction among types of items used) would be excludable from income, but only under strict anti-abuse limitations that:

(1) Provide that length of service awards of more than nominal value can be given to a particular employee only once every five years, but not during the first five years of his or her employment.

(2) Limit safety achievement awards of more than nominal value to no more than 10 percent of an employer's eligible employees per year; managers and administrators, clerical workers and other professional workers could not be eligible employees.

(3) Require a meaningful presentation under conditions and circumstances that do not create a substantial likelihood of disguised compensation.

c. In measuring the $400 average cost limitation under a qualified award plan that permits some awards to be made costing more than $400, awards of only nominal value don't enter into the computation, and costs above the $1,600 excludable limit do enter into the computation.

SEN. LEKNSULT7
4/14 #1

CAPITALIZATION RULES FOR INVENTORY AND TAXPAYER-CONSTRUCTED ASSETS
(Spreadsheet p. 26)

INCENTIVE DEPRECIATION DEDUCTIONS

Proposed Amendment to Chairman's Proposal

Do not require the capitalization of the "accelerated portion" of depreciation deductions (excess of tax over book depreciation) on plant and equipment used to produce inventory or taxpayer constructed assets.

Explanation

Current law requires that depreciation deductions taken for book (financial) purposes (generally straight line) be capitalized as a cost of inventory (i.e. a cost of producing the goods manufactured with the plant and equipment). (Capitalizing a cost in inventory generally postpones the deduction for that cost until the inventory is sold.)

The Chairman's proposal would require the capitalization in inventory of all depreciation taken for tax purposes, including the "accelerated portion" (excess of tax over book) which may, under current law, be immediately deducted.

The amendment would retain current law, that is, the "accelerated portion" of a depreciation deduction would not be capitalized in inventory.

Rationale for Amendment

1. Deferring the difference between tax and financial depreciation (the "incentive" or "accelerated" portion of depreciation deduction) on plant and equipment used to produce inventory or self-constructed assets by capitalizing that amount will dilute the intended incentive effect.

2. Remaining incentive will be distorted among different industries based on varying inventory turnover rates. Industries with high turnover rates (e.g. food) will be little affected while industries with low turnover rates (e.g. steel) could have virtually no incentive depreciation left.

3. Costs of goods sold deduction (which is, in part, determined by the inventory rules) will be divorced from its goal of identifying real economic income; accelerated portion is an incentive, not a real economic cost of producing inventory.

Revenue Effect

The Joint Committee estimates an aggregate $5.0 billion loss (relative to the Chairman's proposal) for the period FY 1986-1991.

SEN. GRASSLEY #2
4/14

CAPITALIZATION RULES FOR INVENTORY AND TAXPAYER-CONSTRUCTED ASSETS
(Spreadsheet p. 26)

RETROACTIVITY

Proposed Amendment to Chairman's Proposal

Do not require the capitalization of the "accelerated portion" of depreciation deductions (excess of tax over book depreciation) for assets placed in service or for which a binding contract has been signed prior to ITC repeal date.

Explanation

Current law requires that depreciation deductions taken for book (financial) purposes (generally straight line) be capitalized as a cost of inventory (i.e. a cost of producing the goods manufactured with the plant and equipment). (Capitalizing a cost in inventory generally postpones the deduction for that cost until the inventory is sold.)

The Chairman's proposal would require the capitalization in inventory of all depreciation taken for tax purposes, including the "accelerated portion" (excess of tax over book) which may, under current law, be immediately deducted, regardless of when the asset was placed in service.

To avoid retroactivity, the amendment would not require the capitalization of the "accelerated portion" of depreciation deductions for plant and equipment placed in service (or for which a binding contract has been signed) prior to the ITC repeal date.

Rationale for Amendment

1. Accelerated depreciation deduction for assets already purchased or committed for will be deferred in inventory, despite ACRS transition rules, without such a change. Thus, a depreciation deduction for machinery purchased in 1982 or a factory building constructed in the 1970's could be deferred past the date it was planned to be taken under current law.

2. Unfair retroactive impact to dilute ACRS for already-purchased assets, whose real cost was computed assuming deductibility of full ACRS.

3. Retroactive legislation, particularly when it impacts investments in plant and equipment made many years ago, is repugnant to basic concepts of fairness.

Revenue Effect

The Joint Committee estimates an aggregate $1.9 billion loss (relative to the Chairman's proposal) for the period FY 1986-1991.

FINANCE 4/16

PENSIONS COVERAGE AND VESTING ISSUES

	CURRENT LAW	CHAIRMAN'S PROPOSAL	SENATOR HEINZ' PROPOSAL
Vesting	10 years	5 years	5 years
Social Security Integration	Unlimited	limited	limited
Coverage	56% or fair cross section	80 % or tighter fair cross section	80% or tighter fair cross section
	No minimum benefit for employees not covered.	N/A	or current fair cross section if minimum 60% benefit to employees not covered.

April 16, 1986

MATSUNAGA AMENDMENT TO PROPOSAL ON BASIC PENSION RULES

ELIMINATE UNNECESSARY BURDENS AND NEED FOR PLAN AMENDMENTS

-- Retain current law rules regarding minimum coverage requirements.

-- Eliminate proposal to apply new minimum participation requirements to qualified plans.

-- Delete proposal to apply a new limitation on the amount of compensation that can be taken into account in determining benefits under a qualified plan.

-- Retain current law with respect to minimum vesting requirements.

-- Retain current law with respect to minimum distribution requirements.

-- Retain current law with respect to deduction limit carryforwards.

-- Retain current law rules governing permissible integration with social security.

-- Retain current law rules governing overall limits on contributions and benefits, except retain proposed exceptions for (i) police, firefighters and pilots (and also corrections officers); (ii) cost-of living arrangements; and (iii) certain health and welfare agencies.

-- Delete proposal to impose special non-discrimination requirements on employer matching contributions.

-- Retain current law regarding hardship withdrawals from 401(k) plans and 403(b) annuities.

-- Provide that plan amendments, if any, required by changes resulting from tax reform need not be made until the the date after January 1, 1989 on which the plan is next amended; provided (i) that the plan complies in operation with the changes as of any separately stated effective date; and (ii) the amendment applies retroactively to any such effective date.

April 16, 1986 8:44 AM

Heinz Amendment to Chairman's Proposals

A. Cash or Deferred Arrangements (401(k)), Tax-Sheltered Annuities (403(b)), Employer Matching and Employee Contributions

1. Index the $7,000 cap on elective deferrals under cash or deferred arrangements and tax-sheltered annuities by reference to percentage increases in the social security taxable wage base.

2. With respect to the nondiscrimination rules for 401(k) plans, employer matching and employee contributions, (a) apply the present law nondiscrimination test applicable to 401(k) plans, and (b) modify the definition of highly compensated employee to conform to the definition used for purposes of coverage, nondiscrimination, and nondiscrimination rules for welfare benefits.

3. Modify the restriction on conditioning contributions and benefits (other than employer matching contributions) on an employee's elective deferrals under a cash or deferred arrangement to grandfather plans in existence on (date of committee action) if (a) under the defined benefit plan, benefits are contingent on the employee elective deferrals; (b) only benefits attributable to elective deferrals may offset defined benefit plan benefits; (c) there is a uniform defined benefit plan match of employee elective deferrals; (d) the defined benefit plan benefits match employee elective deferrals up to 4 percent of pay; (e) there is a minimum interest rate for annuitizing elective deferrals in calculating the offset; and (f) no matching contributions are provided for employee elective deferrals at levels lower than the elective deferrals to which the defined benefit plan benefits are related. In addition, for purposes of determining whether employer matching contributions under the qualified cash or deferred arrangement are provided on a nondiscriminatory basis, the employer's contributions under the defined benefit plan could be taken into account.

B. Simplified Employee Pensions (SEPs)

1. Exclude SEP contributions from employee's income (rather than providing for deduction on Form 1040)

2. Permit employers to make contributions on fiscal year basis

3. Permit coverage requirement (employees working

for employer three of last five years) to be applied on fiscal year basis

4. Raise de minimis employee exclusion from $200 in wages to $300, and index to wage base.

C. **Minimum Standards for Qualified Plans**

1. Coverage

a. Adopt the Chairman's Proposal, with the modifications listed below.

b. Provide an alternative test under which a plan (or plans) of an employer would be deemed to satisfy the revised coverage tests if (i) the plan (or plans) satisfies the present-law fair cross-section test, and (ii) the average benefit provided to employees who do not participate in the plan (or plans) that pass the present-law fair cross-section test, but not the proposed fair cross-section test, is at least 60 percent of the average benefit provided to employees who participate in the plan (or plans). The average benefit provided to employees would be tested for the current year or, at the election of the employer, for the current year and the last four years (or such lesser number than four that the employer elects). Such election could not be revoked without the consent of the Secretary of the Treasury.

c. For purposes of applying the fair cross-section test and the alternative test, permit excludable employees to be disregarded.

d. Provide special rules to accommodate acquisitions and dispositions of business units to provide a period of time after such acquisition or disposition (e.g., until the plan year beginning in the taxable year following the taxable year in which the acquisition or disposition occurs) during which the coverage rules are deemed to be satisfied if (i) the coverage rules were satisfied immediately prior to the acquisition or disposition and (ii) there is no significant change in the coverage under the plan other than the change on account of the acquisition or disposition.

2. Minimum Participation Requirement

a. Modify the rule to require coverage of the lesser of 50 employees or 40 percent of all of an employer's nonexcludable employees to permit a plan to satisfy the fair cross-section coverage test.

3. Integration

a. Permit an employer to limit combined annual benefits attributable to the employer's contributions to social security and annual benefits under the employer's defined benefit pension plan to 100 percent of the employee's final pay (highest year of the last five).

D. **Withdrawal of Benefits**

1. Withdrawals Before Age 59-1/2

a. Provide a limited (for employees other than 5-percent owners) exception from the 15 percent early withdrawal tax on distributions from qualified plans in the case of an unforeseen hardship, which consists of significant medical expenses or casualty losses (amounts in excess of 5 percent of adjusted gross income), or involuntary termination of employment after cessation of unemployment benefits.

b. Modify the proposal so that the 15 percent tax on distributions from qualified plans does not apply in the case of an early retirement, as defined under the plan, by an employee (other than a 5-percent owner) after age 55.

c. In lieu of the 15 percent tax, impose a 10 percent tax (in the case of employees other than 5-percent owners) on early withdrawals of employer matching contributions and earnings, which are attributable to after-tax employee contributions, and a 5-percent tax on early withdrawals of earnings attributable to investments in deferred annuities.

d. Require that employers offer terminating employees the option of a direct transfer (subject to the usual rules requiring spousal consent) of an employee's vested accrued benefits to an IRA or to another qualified plan. Such option would be available only if the employee supplies sufficient information to enable the employer to effect the transfer. Further, revise the notice of rollover treatment required under present law to include a statement that an employee's distribution may be subject to an additional 15-percent income tax if not rolled over to an IRA or to another qualified plan.

e. Modify qualifying annuity rules to enable substantially level distributions from defined contribution plans and IRAs to avoid the tax.

2. Uniform Tax Treatment of Distributions

a. Modify the basis recovery rules for pre-annuity starting date distributions to provide for pro-rata recovery of amounts attributable to employee contributions (aggregating employee contributions, matching contributions, and earnings).

b. Continue to permit long-term capital gains treatment with respect to individuals who attained age 50 by January 1, 1986.

E. 15 Percent Tax on Excess Distributions

1. Delete the proposal to impose a 15-percent additional income tax on annual benefits that exceed the greater of (a) $112,500 or (b) 1.25 times the dollar limit on annual benefits under a defined benefit pension plan.

F. Unfunded Deferred Compensation Arrangements (Sect. 457)

1. Modify co-ordination with other elective contributions to exclude CODAs maintained by rural electric cooperatives.

G. Tax-Sheltered Annuities (Sect. 403(b))

1. Modify special catch-up election for elective deferrals to raise the annual limit to 50% of the elective deferral limit and raise the lifetime limit to $30,000.

H. Life Insurance and Health Plan Nondiscrimination Rules

1. Adopt the Chairman's Proposal, with the modifications listed below.

2. Provide an alternative test under which a plan (or plans) of an employer would be deemed to satisfy the coverage tests in the Chairman's proposal if (i) the plan (or plans) satisfies the present-law fair cross-section test, (ii) the average benefit provided to employees who do not participate in the plan (or plans) that pass the present-law fair cross-section test, but not the proposed fair cross-section test, is at least 60 percent of the average benefit provided to employees who participate in the plan (or plans) being tested, and (iii) at least 80 percent of the employer's nonhighly compensated employees are eligible to participate in a plan (or plans) of the employer that provides a benefit that is at least 40 percent of the average benefit provided to employees who participate in the plan (or plans) that pass the present-law fair cross-section test, but not the proposed test.

The average benefit provided to employees would be tested for the current year or, at the election of the employer, for the current year and the last four years (or such lesser number than four that the employer elects). Such election could not be revoked without the consent of the Secretary of the Treasury.

3. For purposes of applying the fair cross-section test and the alternative test, permit excludable employees to be disregarded.

4. Provide special rules to accommodate acquisitions and dispositions of business units to provide a period of time after such acquisition or disposition (e.g., until the plan year beginning in the taxable year following the taxable year in which the acquisition or disposition occurs) during which the coverage rules are deemed to be satisfied if (i) the coverage rules were satisfied immediately prior to the acquisition or disposition and (ii) there is no significant change in the coverage under the plan other than the change on account of the acquisition or disposition.

5. Clarify that the waiting period of up to one year of service is permitted for noncore benefits (i.e., dental, vision, psychiatric, orthodonture, cosmetic surgery). Permit the Secretary of the Treasury to expand the list of noncore benefits in regulations. Noncore benefits could be tested separately from core benefits under the coverage tests.

6. Provide that no more than 40 percent of the participants in a plan may be highly compensated employees, unless the plan is noncontributory and provides universal coverage of regular, full-time employees.

I. Limits on Contributions and Benefits

1. Modify special rule for reduction of dollar limits on benefits applicable to police, firefighters, and pilots to include correctional officers.

J. Miscellaneous Modifications

1. Effective Dates

a. Delay the effective date to plan years beginning after December 31, 1988, of (1) the new nondiscrimination rules for cash or deferred arrangements and the new rules on withdrawals, conditioned benefits, and service eligibility, (2) the new nondiscrimination rules for employer matching and employee contributions, (3) the new coverage rules, (4) the new minimum participation requirements, (5) the definition of includible compensation, and (6) the required benefit commencement rule.

2. Required Regulations

a. Require the IRS to issue final regulations on the proposals requiring substantial change of plan documents (e.g., nondiscrimination rules, coverage, integration) by January 31, 1988, in order to give employers time to make plan amendments before the effective date.

DANFORTH
4/16

Possible Amendment to Chairman's Proposal

Under the amendment, a participant in a section 501(c)(18) pension plan would be permitted to make annual deferrals of up to $7,000 under the plan on a before-tax basis. Under the amendment, the cap on the employee's elective deferrals under a cash or deferred arrangement would be reduced dollar-for-dollar by the employee's before-tax deferrals under the section 501(c)(18) pension plan. An employee's annual IRA deduction limit would be reduced dollar-for-dollar by the employee's before-tax deferrals under the section 501(c)(18) pension plan and under a cash or deferred arrangement in excess of $5,000.

The Washington Post

OUTLOOK

INSIGHT

The Poor Subsidizing the Rich

'Pension Integration' Is Just a Fancy Way of Saying Rip-Off

By Karen Friedman

THOUSANDS OF workers are losing badly needed retirement dollars because of a pernicious pension practice that robs from the poor to give to the rich. Congress has the chance to solve this problem once and for all, but it looks like they're going for a compromise.

"Pension integration," as it's called, is a sophisticated way for pension plans to pay disproportionately large benefits to higher-paid workers at the expense of the lower-paid. At its worst it can even eliminate the pension entirely.

In its simplest form, integration means that a pension plan takes into account an employe's Social Security when calculating the pension benefit. When employes are told that they are earning benefits under a pension plan, they don't realize that Social Security may be figured into the total amount of those benefits. They believe that what is being paid into the pension fund on their behalf will be used to "buy" a pension. In fact, it may be buying a pension for the higher-paid workers, leaving lower-paid workers to discover that Social Security provides the bulk of their pension.

The practice may be little known, but it's widespread: 9.7 million people, more than half of the employes in pension plans in medium and large companies, are affected by integration. Most employes in small businesses are also in integrated plans. (Most union-negotiated plans do not use this practice.)

A typical formula might subtract 50 percent of the Social Security payment from the pension benefit. Marge Boley, of Columbus, Ohio, worked 20 years as a sales clerk for the J.C. Penney Co. and expected a pension based on all her years on the job. Only when she retired did she discover that the company subtracted an amount equal to 50 percent of her Social Security from her small pension, wiping out her pension completely. (J.C. Penney has since modified the integration formula. According to the company, under the new plan, she would have gotten $17.50 a month.)

Karen Friedman is education director for the Pension Rights Center.

Pension integration is so complex that the few workers who learn of it usually find out about it the same way Marge did—after retirement.

The tax proposal by Sen. Bob Packwood (R-Ore.) now before Congress includes provisions that would modify integration.

However, rather than eliminating integration completely, the proposal resorts to a compromise that would clear up the worst abuses while leaving intact the basic unfair structure of integration—and one that necessarily discriminates against low-income workers.

Essentially, the Packwood proposal would prevent situations such as Marge Boley's by ensuring that an employer who integrates a plan cannot take away more than half of an employe's pension benefit.

Similar provisions are included in the Retirement Income Policy Act (RIPA) which was introduced by Sens. John Heinz (R-Pa.) and John Chafee (R-R.I.) and Rep. William L. Clay (D-Mo.).

Let's look at how the legislation would work in a real situation. Mrs. B. worked for a bank in California and retired with a monthly benefit of $82.37, after 50 percent of her Social Security was taken into account. Under RIPA someone in Mrs. B's situation would get approximately $149.00 a month. Certainly any increase helps. However, it is still relatively little compared to what she would have gotten if no integration were used—$298 a month, about 3½ times the size of the pension she is entitled to now.

Employers argue that they have the right to skew benefits to the higher-paid employes because the Social Security system pays a higher proportion of the benefits that the lower-paid employes get.

This argument is absurd. Higher-paid employes have an abundance of assets—stocks, bonds, savings, real estate, tax shelters—that low-income people don't have. These extra assets more than make up for the "tilt" in Social Security toward the lower-paid. Social security is now averaging just $5,736 a year for the typical worker and recent studies show that savings for most low and moderate wage earners are almost nonexistent.

Integration advocates further say that they are aiming for a "retirement income goal" that takes into account both pensions and Social Security. They say if they didn't integrate the plan, an employe could conceivably get more in retirement than while working. If this rare event should occur—which is only possible if someone spends a lifetime with one company—then the plan could provide a "cap" only if the expected pension is more than the worker's pre-retirement earnings.

Finally, pension-plan consultants and actuaries—who make a bundle selling integrated plans—charge that if integration were eliminated, companies would stop setting up plans. They contend that pensions must serve management objectives. Companies must be able to use pensions to attract, retain, and finally ease out higher-paid employes as suits their business needs. If they had to pay bigger pensions to the rank and file, they say, pension plans would be too expensive and employers would opt out of the system.

It is this argument which sent the sponsors of the Retirement Income Policy Act on their compromising course.

Each time a new pension law is proposed, the consultants insist that companies will stop providing plans. But this is just another "cry wolf" tactic. Most employers, in fact, have continued to offer plans because there are plenty of economic incentives to do so, including handsome tax breaks, and hefty pensions for top executives—just to name a few.

Pension integration belongs to a bygone era, when pension plans weren't much more than gifts to a few long-term employes.

But times have changed. Pensions are acknowledged deferred wages earned by employes to guarantee them decent income in retirement. Americans pay taxes to encourage private pension plans that get a subsidy of $35 billion in tax breaks—the largest of all federal tax subsidies.

These expensive tax incentives are meant to encourage employers to set up and contribute to pension plans for their rank-and-file workers—not to perpetuate a Robin-Hood-in-reverse policy.

If Congress is serious about developing a long-range pension policy that will protect future generations of retirees, then this outdated practice must be stopped.